INVESTMENT STRATEGY GROUP

OUTLOOK 2025

JANNEY MONTGOMERY SCOTT LLC

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OUTLOOK 2025

OVERVIEW

Outlook 2025 offers the Janney Investment Strategy Group's baseline prognostications for the economy, the equity and fixed-income markets, their evolution, and investment implications in the New Year.

- Our economic and financial market views have been reinforced to a degree by the U.S. election. Growth should continue and translate favorably for stock prices.
- The job market is stable, and wage gains, while slowing, remain positive on an inflation-adjusted basis. An accruing amount of savings and steady employment bodes well for household spending.
- Major trade action from the Trump administration and the handling of immigration are variables that could alter the otherwise sanguine landscape. Sequencing and magnitude will matter.
- Corporate profits are expected to climb meaningfully, which will be needed to justify the stock market's lofty valuation. Better news abroad should help to support multinational revenues.

- Continued productivity growth and still-moderating inflation should allow the Federal Reserve to lower interest rates two more times; longer-term interest rates likely remain range-bound.
- Competing political forces make the fiscal outlook very hard to judge, and longer-term interest rates will be more responsive to Washington's policy decisions than is typical.
- Valuations on investment grade and high yield corporate bonds and municipals are steep, but healthy credit conditions mean any weakness will probably be met with strong demand—buy any dip.
- Overseas developed market bonds represent an opportunity to capture relatively high income without some of the fiscal risks that are likely to dominate the U.S. bond market in 2025.

ECONOMY & EQUITY MARKETS

MARK LUSCHINI, CMT
Chief Investment Strategist

President and Chief Investment Officer, Janney Capital Management

Mark Luschini serves as Janney's Chief Investment Strategist and leads the Investment Strategy Group, which sets the firm's view on macroeconomics, as well as the equity and fixed income markets. In addition, Mark is the President and Chief Investment Officer of Janney Capital Management (JCM), the asset management subsidiary of Janney Montgomery Scott. Under his leadership, JCM has delivered competitive results across its suite of investment strategies and grown its assets under management to more than $3.7 billion.

Mark has spent more than thirty years in the investment industry. He draws on that experience to speak on topics related to macroeconomics and the financial markets at seminars, client events and conferences. He is frequently quoted in publications ranging from the Wall Street Journal and Barron's to the New York Times and USA Today. In addition, he regularly appears in various media outlets including CNBC, Fox Business News, and Bloomberg Television and Radio. He has an undergraduate degree in Psychology and an MBA in Finance from Gannon University and holds the Chartered Market Technician (CMT) designation from the Market Technicians Association.

Domestic economic activity is operating at an above-trend pace. Both the non-partisan Congressional Budget Office and the Federal Reserve estimate potential growth in U.S. Gross Domestic Product (GDP), a measure of a country's overall output, to be about 2.0%. Yet the annualized rate in the U.S., according to the most recent report from the government for 3Q24, was 2.8%. Inside that release, a component called final sales to domestic purchasers, which is an excellent indication of spending (a driver of almost 70% of the U.S. economy) because it strips away the highly volatile variables of trade and inventory balances, posted 3.2% annualized, the best this year. A real-time but somewhat imprecise measure updated by the regional Federal Reserve Bank of Atlanta has been trending at that level or higher throughout the fourth quarter. Collectively, this demonstrates a high degree of economic momentum leading into the opening months of 2025.

Chart 1: US GDP

(Source: Janney ISG, BEA)

Prognostications are always subject to wrinkles that occur, which could alter their trajectory, and today, there are more than a few patchy clouds that might either bring rain or pass benignly, clearing the way for our forecast for sunny skies. These mostly relate to the incoming Trump administration's agenda, although loitering geopolitical risks seem to be a permanent fixture that must always be accounted for. There are four pillars to President-elect Trump's proposed policies: regulatory, fiscal, trade, and immigration. On the deregulation front, his agenda is likely to be somewhat bullish for growth and potentially disinflationary. In terms of growth, the first Trump presidency saw far fewer economically significant rules published, so we expect quite a bit of red tape to be sliced next year and beyond. Trump's fiscal policy, particularly the business-friendly statutory tax that may be lowered and relief on taxable incomes for individuals, should also exert an optimistic impulse. We acknowledge it could also be bearish if it is too expansionary as it could cause inflation to reaccelerate, the Federal Reserve to stand pat on further rate cuts pushing longer-term yields higher, and in turn, thwart demand. Barring that, our central view is that Trump's regulatory and fiscal agenda will likely be positive for growth and corporate profits.

The U.S. is a relatively closed economy; as such, it is much less reliant on exports to fuel activity. However, the imposition of tariffs could have a two-fold effect. First, it will raise prices on goods shipped to the U.S. from countries to whom tariffs are applied, effectively passing those costs on to U.S. customers. While some domestic importers may choose to eat part of those costs, many will protect their margins by sharing the price hikes with their customers, be they wholesale or retail. The "tax" of higher prices could counter some of Trump's other growth-spurring policies. The other impact could be felt if these same countries retaliate and impose tariffs on U.S. exports. The game of chicken that ensues will, if nothing else, raise global uncertainty, sowing the seeds for attacks on the U.S.'s hegemony and potentially the U.S. dollar as the world's reserve currency. We also expect action on the immigration front. On the legislative side, immigration reform is possible, but next year, the executive side can move more quickly to deport illegal immigrants. The administration may also focus on requiring companies to better screen job applicants for immigration status. Near term, an immigration crackdown could result in a modest tightening of the labor market. Still, over the longer term, a reduction in immigration would be negative for U.S. potential growth. It could be inflationary considering the ongoing skill gap that exists in certain industries that need to fill many positions currently occupied by immigrant workers.

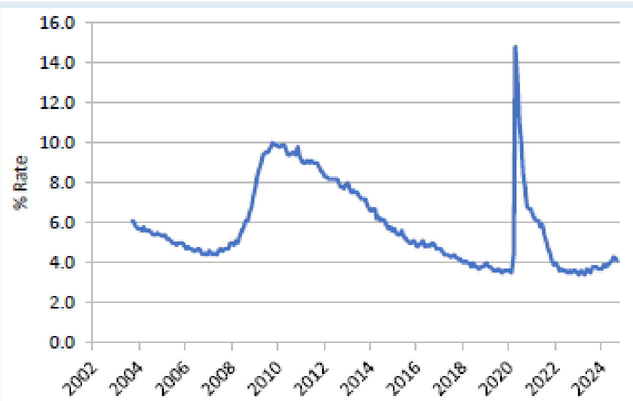
On balance, the positive thrust from fiscal and regulatory policy should not be derailed if a measured approach to trade action and immigration treatment is administered—thus, our theme of "mostly sunny with patchy clouds" alluding to our optimistic outlook tempered by the potential for scattered but stormy conditions.

Meanwhile, helping to bolster the state of the economy is the labor market. To be sure, the pace of job growth has moderated some, and the unemployment rate has broken north of 4%; however, both are still strong enough in the case of the former, and low enough in the case of the latter, to suggest households should remain armed to consume at a level that is sufficient to forcefully propel growth. A leading indicator regarding the health of the job market is weekly jobless claims. While imperfect at times when they can be distorted by weather or a strike, the figures usually demonstrate the degree to which companies are shedding workers, and if a pattern of losses is developing, that would indicate a persistent, weakening condition. Conversely, falling claims show that fewer workers are pursuing insurance benefits from their local unemployment office, which is usually a sign that plentiful job openings are luring them back into the workforce. The fact that claims have been steady and low, especially as a percentage of the total working population, is one of many positive signals emanating from the labor market.

Inflation was a dominant concern expressed in exit polls, which shows it was at the top of people's minds when stepping into the voting booth in November. After hitting a 40-year high of 9.1% in June 2022, it has receded toward the Federal Reserve's stated target of 2%. However, core measures of inflation, which strip out food and energy prices, remain somewhat stickily above that goal.

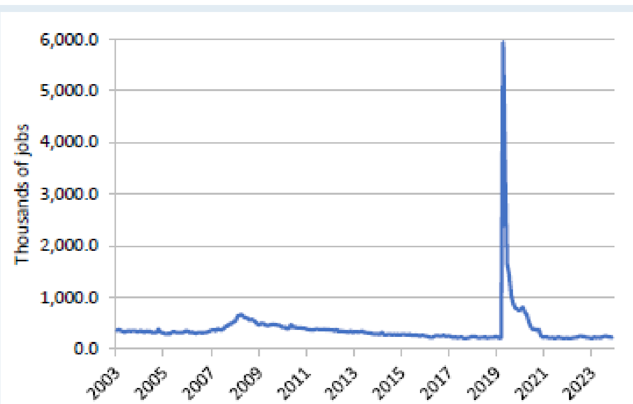
Policymakers have begun to reduce interest rates to prime the economy while at the same time working further to trim inflation. Further reductions beyond those taken so far are likely; however, the number and the cadence will depend on the evolution of the consumer price readings and labor conditions. Indeed, even as the rise in inflation has decelerated, the vestiges of its increase remain in elevated prices for goods and services. It will take time for incomes to catch up to the point where higher price levels are less impactful than current, but consumers are starting to feel a tad better about that prospect. Consumer confidence surveys, such as those from the Conference Board, have improved, with the most recent print at the highest level in over a year. In that same survey, more respondents indicated that jobs remain plentiful versus those stating they are hard to get, a telling insight about the outlook for jobs and sentiment about job security.

Chart 2: US Unemployment Rate



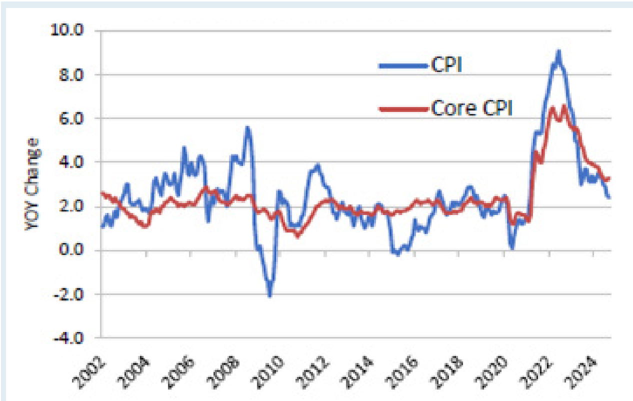
(Source: Janney ISG, Bloomberg)

Chart 3: US Initial Jobless Claims Rate



(Source: Janney ISG, Department of Labor)

Chart 4: Consumer Price Index vs Core CPI



(Source: Janney ISG, BLS)

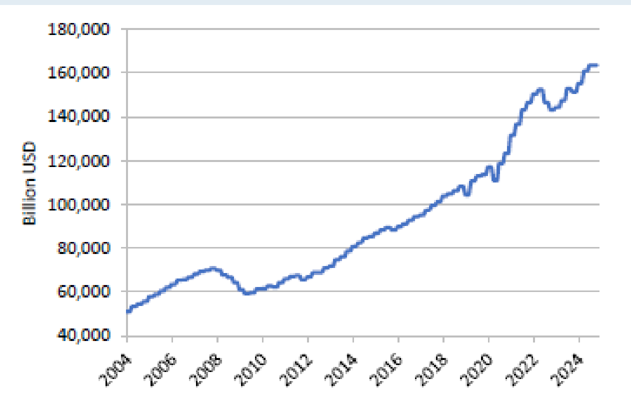
Chart 5: Conference Board Consumer Confidence

(Source: Janney ISG, Conference Board)

Household balance sheets are in good shape, helping to bolster the propensity of Americans to consume. Aggregate net worth in the U.S. hit an all-time high, lifted by financial assets and, importantly, housing values since more households own homes than stocks. Since the tendency to spend is lifted coincident with rising net worth, it sets the table for consumption to ensue. Delinquencies on credit facilities, especially revolving lines and auto loans, which had been creeping to eerily high levels, have begun to recede. Additionally, robust spending behavior has not led to a re-levering of debt to the point where the service costs are unmanageable. Indeed, they remain below pre-pandemic ratios.

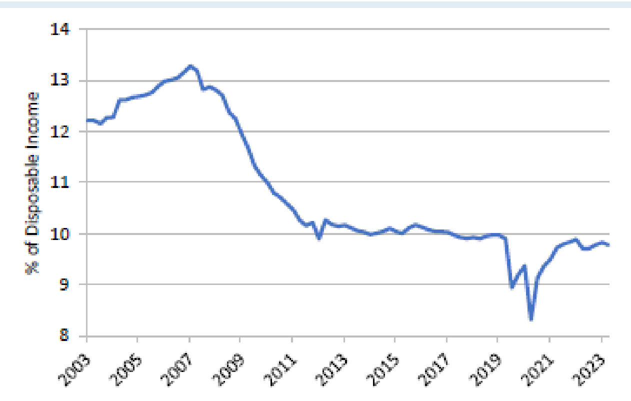
The business community is generally faring well, if somewhat unevenly. Manufacturing activity has begun to rebound as the COVID-induced, capital goods buying binge-to-bust normalizes. While it is not fully recovered, purchasing managers are seeing a strengthening pipeline of new orders. The services sector, which encompasses just under 80% of the U.S. economy, already reports robust activity as travel, leisure, and entertainment spending continues to go gangbusters. Together, surveys of corporations, including small companies (important since those with fewer than 500 workers host 82% of the jobs in this country), indicate that they expect favorable conditions looking forward.

Chart 6: US Household Net Worth (Nominal USD)



(Source: Janney ISG, Federal Reserve)

Chart 7: US Household Debt Service Ratio



(Source: Janney ISG, US Census Bureau)

Chart 8: ISM Manufacturing Index

(Source: Janney ISG, ISM)

Chart 9: ISM Non-Manufacturing Index

(Source: Janney ISG, ISM)

Of concern is the impact on industry by way of a trade policy (tariffs) that levies a high toll. Tariffs are likely for two reasons. They will be viewed by the Trump administration, and potentially by Congress, as a source of revenue that will help offset the impact of planned tax cuts on the deficit. The executive branch can also implement tariffs without congressional approval, and Trump appears serious about levying them either softly as a negotiating ploy or as a hard, targeted tool to extract a better trade deal. Next year, a broad-based unilateral tariff such as 10% on all U.S. imports or a large tariff on imports from China, could cause a shock in prices or disruptions to businesses having to reorder supply chains.

RISKS TO MONITOR

- On the domestic front, much depends on the severity of, and possible retaliatory response by trade partners to the likely application of higher and broader tariffs. As a regressive tax that burdens the cohorts in the lower income brackets disproportionately, spending could be curtailed.
- Inflation remains at a level that requires the Federal Reserve to maintain a rather restrictive interest rate policy, which could squeeze demand and add more friction to slow the economy.
- Exogenously, conflicts in Eastern Europe and the Middle East, simmering tensions between China and Taiwan, North Korea's involvement in the war between Ukraine and Russia, and a political kerfuffle in countries such as France and South Korea, are all worthy of monitoring for developments that could insert a geopolitical risk premium in asset prices.

CONCLUSION

The economy is operating above trend, and we expect it to continue through 2025, but the labor market is always key to handicapping the likelihood of that outcome. With recent employment reports showing healthy conditions in the labor market, the economy's footing is stable. Households and businesses have expressed improving sentiment about the outlook over the coming quarters, which should further cement the spending cycle necessary to propel the economic expansion through our forecast window.

INVESTMENT IMPLICATIONS

The solid economic backdrop underscores our bullish stance. Inflation is moderating, and the Federal Reserve appears to have successfully engineered a recession-less landing by slowing demand without inflicting painful job losses. Internationally, Europe remains weak, but China has taken increasingly more aggressive steps to reflate economic activity, which has fallen shy of its target. Since China's imports are other countries' exports, especially Asia, Japan, and Europe, measures taken by Chinese authorities to accelerate growth will radiate to others as well. As a result, we expect global activity to improve over 2025, further supporting stock prices.

- **Global Equity Markets** — U.S. equities should advance predicated upon the realization of corporate profit, estimated to expand by double digits over the next 12 months. Valuations are demanding, which requires the economic news received to be good enough to underpin those expectations. Given the Trump administration's ambitious agenda on domestic policy and trade, plenty could induce bouts of volatility; therefore, expectations should be tempered given progress toward those gains may be tested.

  The valuation disparity in foreign equities, when compared to the U.S., is compelling. Still, a catalyst is needed to jump-start the earnings growth that would invite investors to shift capital to overseas bourses. China's effort to meaningfully stimulate its economy and other countries experiencing improving activity will likely help to weaken the U.S. dollar and solicit more interest in overseas markets later in the year.
- **Sectors** — The tech and tech-related companies found in Technology, Communications, and Consumer Discretionary should continue to draw investor interest. Industrials will benefit from the spending directed at reshoring industries and a potential uptick in capital expenditures should spirits in the business community continue to lift. Also, historically staid Utilities will get a boost from the exponential demand for energy needed to supply the tech industry and the decarbonization evolution. Favored secular themes include defense companies, cybersecurity, generative artificial intelligence, genomics, and robotics.
- **Commodities** — Industrial metals, such as copper and uranium, should benefit from expenditures on infrastructure, decarbonization, and electrification, both here and abroad. Used as a hedge in a diversified portfolio, precious metals, namely gold, may be employed in part to address the risk of a geopolitical event or inflationary shock.

VARIOUS ECONOMIC SCENARIOS AND PROBABLE OUTCOMES

Our prognostication for the U.S. stock market's path forward includes three outcomes that emanate from various economic scenarios that could unfold; below we assign a probability to each. In preview, we remain constructive; however, we think bouts of severe volatility may emerge as fiscal policy interacts with trade tensions to interrupt bullish sentiment from time to time.

Scenario 1: Blue Skies

The economy expands at an above-trend pace while the Trump administration successfully legislates on the extension of the Tax Cuts and Jobs Act and wields an axe to GDP-sapping regulations that unlock corporate animal spirits and business spending abounds. While inflation grinds lower, allowing the Federal Reserve to remove its tight monetary stance, albeit glacially, it does not encumber the economy. Tariffs and immigration policies are imposed in a deliberate and measured way. Geopolitical concerns abate as negotiations in Eastern Europe and the Middle East serve to freeze tensions from escalating. Corporate earnings expand at a double-digit pace, employment conditions are solid, and interest rates remain at a relatively benign level. Investors take their cue from improving sentiment and the market's multiple trades on 2026 earnings estimates of more than $300, driving the S&P 500 index to 7,000.

Probability: 15%

Scenario 2: Mostly Sunny with Patchy Clouds

The Trump administration encounters some challenges in advancing its agenda on tax cuts and economic-boosting deregulation. Tariffs are applied discriminately, but their friction is insufficient to deter consumers from normal spending levels since the labor market remains healthy and wage gains exceed waning levels of inflation. The Federal Reserve moves overnight rates somewhat lower, and yields across the curve decline marginally, supporting business and household credit demand. Several normal and customary equity market drawdowns occur as President Trump moves quickly to implement his policies, but investors look through it, and stocks recover quickly. Corporate earnings rise, supporting higher stock prices even as the market's already lofty valuation limits the additional gearing from multiple expansion. The S&P 500 index reaches 6,600.

Probability: 75%

Scenario 3: Downpour

The lagging effects of the Federal Reserve's restrictive monetary policy cool the labor market to the point that unemployment begins to rise. Households withdraw from spending to bolster savings as job security sentiment wavers. Imposing tariffs across a broad range of imported goods causes prices to rise, exerting a negative impulse on demand. At the same time, the deportation of illegal immigrants and/or the curtailment of migrants that absorbed many of the positions in the services and construction industries causes wage inflation to reassert itself, threatening consumer inflation expectations to become unmoored. Worries of a recession mount while the Federal Reserve speaks of abandoning its rate-cutting cycle to address the risk of an acceleration in inflation. Stocks are derated from their elevated valuation and decline in a deep correction to 5,500 on the S&P 500 index before rebounding to 5,850.

Probability: 10%

BOTTOM LINE: ENSEMBLE FORECAST

Our weightings lean into a favorable outcome. In fact, simple math demonstrates that we assigned a 90% probability to an outcome that delivers a price level for the S&P 500 index that is higher than where it stands at the time of this writing. However, the potential imposition of trade tariffs, the path the Trump administration pursues on immigration, or an unwelcome turn in geopolitical events may require us to reset our sanguine expectations.

FIXED INCOME & INTEREST RATES

GUY LEBAS, CFA®
Chief Fixed Income Strategist

Director of Custom Fixed Income Solutions, Janney Capital Management

Guy LeBas is responsible for providing direction to the firm's clients on the macroeconomic, interest rate, and bond market investing climate.

Guy authors bond market periodicals which provide relative value recommendations across the fixed income spectrum. Bloomberg named him the most-accurate forecaster of the Treasuries market in 2015 and previously recognized him as a "Bloomberg Best" for his work in bond market forecasting.

Prior to joining Janney in 2006, Guy served as Interest Rate Risk Manager for U.S. Trust's bank asset and liability portfolios, a role in which he oversaw risk and return on an $11 billion balance sheet. He received his education from Swarthmore College and is a CFA Charterholder.

In our *Outlook 2024* publication, we highlighted the split economic potential: the U.S. would either fall into a garden-variety, end-of-cycle slowdown, or benefit from productivity gains. It took until 3Q, but the U.S. private sector is now benefiting from a big boost in economic productivity. Given the economic trajectory, expectations of massive Fed rate cuts faded, and interest rates moved somewhat higher during the year. There were numerous trading opportunities, with interest rates trending across several regimes throughout the year.

Credit markets meanwhile held strong, with investment-grade (IG) and high-yield (HY) corporate spreads tightening considerably and validating our neutral-to-positive stance. Municipal bonds, while volatile due to supply shifts, outperformed expectations thanks to robust pension funding and state and local government fiscal health. Owing to this sectoral strength, as well as the high starting point of yields in 2024, bond market total returns have been healthily positive.

INTEREST RATE OUTLOOK

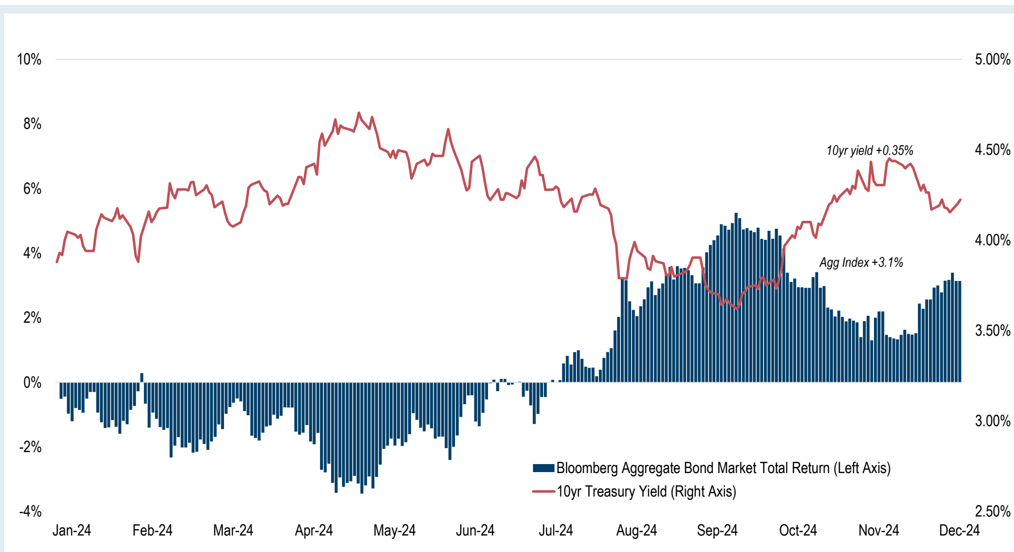
Markets kick off 2025 with interest rates well above the three-decade average, but spreads in IG and HY near their tightest in history.

While the private-sector economic outlook is firming and Federal Reserve monetary policy is on a relatively smooth path, bond markets have largely priced in this outcome. Solely from a private-sector and Fed standpoint, we view today's roughly 4.20% 10-year Treasury yield as fairly valued overall. The challenge for 2025 is that fiscal policy presents some significant risks, and they are universally skewed toward higher yields. We summarized some of those risks in our election policy preview, but they largely boil down to deficit expansion, tariffs, and changes to the growth of the U.S. labor force:

- Deficit expansion from tax cuts risks steepening the yield curve as longer-term bond issuance increases in the coming year.
- Proposed tariffs, should they emerge, risk an increase in price levels that could force a Fed policy response.
- A shrinking labor force from deportations and reduced immigration risks renewing labor shortages and reigniting a wage/price spiral.

We anticipate, in the absence of these upside risks, that the Federal Reserve will cut overnight interest rates two times in 2025 and that intermediate and longer-

Chart 10: Yields Are Higher in 2024 (Red), But Strong Income Generation Generated Positive Returns for Bond Markets (Blue)



(Source: Janney ISG; Bloomberg)

term interest rates will decline slightly during the year. At the time of publication, there are three rate cuts priced into 2025, so our outlook is not far from consensus. In our base case scenario, bond market returns should be coupon plus a small margin. But the aforementioned policy risks—and particularly their skewed ability to push rates higher rather than lower—still leave us wary. One way to avoid the biggest downside from possible policy decisions is to avoid the market sectors most sensitive to supply, namely 20-year and longer government bonds.

Table 1: Base Case Interest Rate Projections

	Fed Funds	2yr UST	10yr UST	30yr UST
4Q2024	4.375%	4.20%	4.30%	4.45%
2Q2025	4.125%	4.28%	4.05%	4.35%
4Q2025	3.875%	4.25%	4.20%	4.60%
4Q2026	3.375%	3.50%	3.75%	4.35%

(Source: Janney ISG; US Treasury Dept.; Federal Reserve Board)

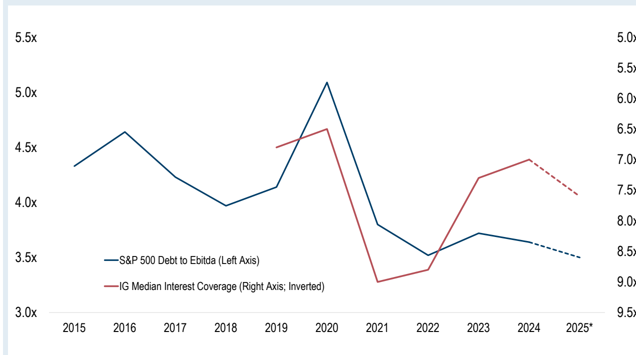
SECTOR OUTLOOK

When it comes to the corporate sector, 2025 is likely a year of continued profit growth, heavy bond issuance, and flattish credit fundamentals. Median analyst expectations are for S&P 500 companies (a decent proxy for the IG corporate markets) to grow earnings by 8%, whereas IG bond issuance forecasts are in the $700 billion - $800 billion range net of maturities. That combination would put the gross debt-to-EBITDA ratio, a measure of firms' ability to service debt, at 3.50x, roughly unchanged over the last three years. The share of public HY-rated companies earning less than their annual debt service payments is, meanwhile, near a long-term low at about 17%. While that last statistic is an exceedingly simple measure of credit stress, it does hint that the distribution of credit fundamentals skews positively as well. On a high level, these numbers suggest stable fundamental credit quality.

The challenge in the credit markets is that valuations are very full: IG credit spreads at 0.78% are currently in the second percentile of the last 30 years, and HY spreads at 2.63% are in the third percentile. We anticipate the credit markets will remain well-supported in 2025, but the risk is obvious. With spreads that narrow, a relatively modest widening can negate much of the incremental carry from credit relative to Treasuries. For that reason, we start the year "neutral" on both IG and HY credit, but given the fundamental strength, we also believe it makes sense to add on any material widening, loosely defined as +0.15% on IG and +0.40% on HY.

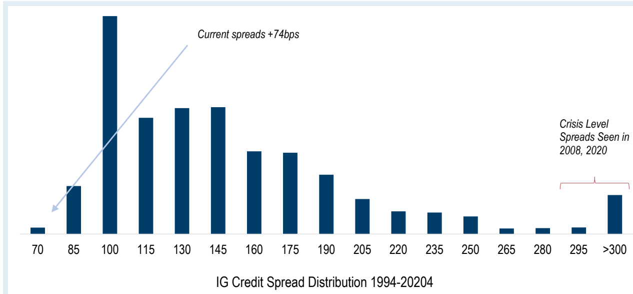
One alternative to fully valued IG credit remains the agency mortgage-backed securities (MBS) markets, a sector on which we have been positive since 2Q24. MBS spreads remain relatively wide compared to the sector's own recent history, which strikes a significant contrast to the aforementioned tight spreads on IG credit. MBS should benefit from continued reductions in interest rate volatility as the path of Fed policy becomes clearer in early 2025.

Chart 11: Corporate Leverage and Debt Service Coverage Set to Improve Further in 2025



(Source: Janney ISG; Bloomberg; S&P Global Intelligence; Factset; *2025 estimated)

Chart 12: IG Credit Credit Spreads in the Lowest 2% of History HY (Now Shown) Similarly Valued

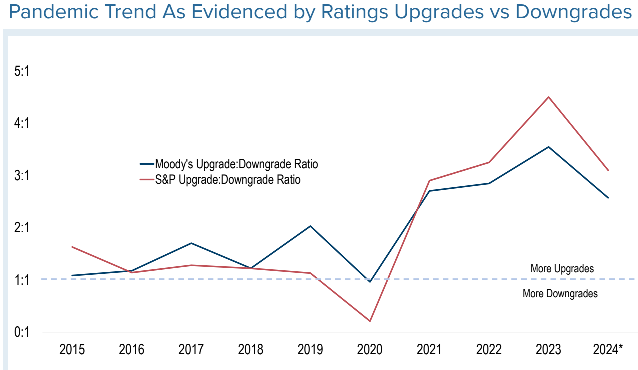


(Source: Janney ISG; Bloomberg)

TAX-EXEMPT MUNICIPALS

Municipal markets share some of the same characteristics as IG credit. Granted, data are much delayed, but credit fundamentals in the municipal markets appear strong. One notable trend in 2024 was issuers' willingness to tender for outstanding bonds to reduce indebtedness. As of October month-end, the pace of tenders in 2024 was running 24% above the prior year and far above the almost nonexistent tenders before that. The increasing frequency of tenders is a small symbol of improved aggregate credit quality in the municipal markets. More obvious, however, is the ratio of credit upgrades to downgrades, which was quite positive this year, capping off a trend in place since 2021.

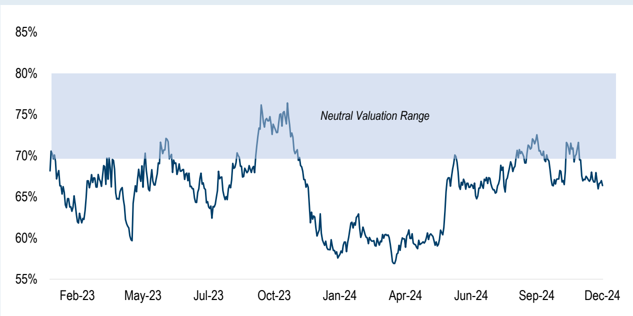
Chart 13: Municipal Issuers' Credit Quality Has Improved Above Pre-Pandemic Trend As Evidenced by Ratings Upgrades vs Downgrades



(Source: Janney ISG; Moody's Investor Services; S&P Global Intelligence; *2024 YTD)

Pricing in municipals is expensive in a historical context but is clearly less stretched than in IG corporates. Muni-to-Treasury ratios in the 10-year area of the curve are presently around 67% after spending much of 2024 below the 60% mark. The post-COVID average in ratios has been about 75%, so by this measure, while valuations are on the higher side of history, they are by no means as stretched. As a result, we are more comfortable with healthy relative performance in tax-exempt municipals than in IG credit for 2025.

Chart 14: Ratio of Muni to Treasury Yields Below LT Average But Valuation Not Nearly As Stretched as for IG Credit



(Source: Janney ISG; Bloomberg)

LOOKING OVERSEAS

One area of opportunity we see for 2025 is the foreign-developed government bond sector. The core of our thesis is that foreign government debt, especially when currency is hedged back into U.S. dollars, will deliver a similar starting yield to USD-denominated debt, though with less exposure to the fiscal policies that create upside risk to Treasury yields. While yields overseas are nominally lower than for U.S. Treasuries, currency hedging in EUR, CAD, AUD, and JPY currently provides positive incremental carry. GBP-denominated government bonds, meanwhile, have similar nominal yields to Treasuries in addition to a possible currency hedging benefit.

Table 2: Foreign DM Bonds Offer Good Carry & Lower Political Risks

	Central Bank Bias	Nominal Yield	Currency-Hedged Yield
Japan 10yr	Neutral to Tightening	1.06%	4.39%
UK 10yr	Moving to Easing	4.32%	4.30%
Canada	Actively Easing	3.04%	3.94%
German 10yr	Actively Easing	2.12%	3.82%
Australia 10yr	Moving to Easing	4.14%	3.72%
US 10yr	Moving to Neutral	4.20%	4.20%

(Source: Janney ISG; Bloomberg)

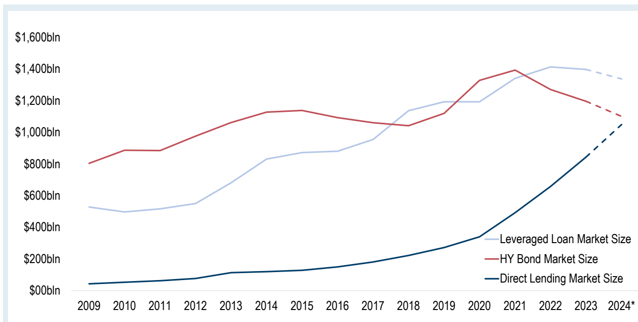
The real advantage of overseas holdings at present is twofold. First, even while the Fed is looking at slowing or even ending its cutting cycle in 2025, most major central banks (except for Japan) are looking at maintaining their easing in the coming year. The ECB is a perfect example. After hinting at a few short cuts, ECB President Lagarde has recently guided towards a series of cuts to support deflationary impulses. Unlike in the U.S., productivity gains are providing far less in the way of economic tailwinds in Europe. Second, fiscal authorities in nearly every other major developed market other than the U.S. are deeply divided. One needs to look no further than the recent political turmoil in France—ostensibly on budget issues—and the resulting collapse of parliament for an example. Divided governments simply do not have the political capacity to embark on fiscal adventurism, though the same cannot be said of the U.S.

BIRTH OF A SECTOR: PRIVATE CREDIT

The last two years have seen an incredibly fast development, rare for the fixed-income markets. That development is the birth of the private credit sector. While private lending has been part of institutional markets for decades, it was mostly contained to either floating-rate leveraged loans owned by funds or long-term infrastructure-related debt owned by insurers. Most "normal" loans were the province of banks. In recent years, changes in bank capital rules have made it less efficient for banks to fund commercial and industrial loans and allowed private asset managers to expand into the lending markets. Thus, private credit was born. And it grew incredibly rapidly from 2022 to 2024, aided by an influx of capital.

It is impossible to paint private credit markets with a single brush as estimates of potential market size *start* at around $10 trillion, about nine times the size of the index-eligible high-yield bond markets. Borrowers range from middle-market companies to real estate projects to packages of consumer loans. What unites (most) borrowers in the sector is that they need complex financings that are hard to achieve in the traditional bond markets.

Chart 15: Private Credit Markets Set to Overtake More Traditional Forms of Speculative Grade Financing in Coming Years



(Source: Janney ISG; Federal Reserve Board; McKinsey & Co; 2024 Est.)

While the market offers advantages to borrowers like tailored structuring and confidentiality, it also comes with challenges for investors, including illiquidity and limited transparency. There is a wide range of sponsors in the sector that collect capital from investors and deploy it into private loans—in many cases, a single sponsor provides the entirety of a loan, unlike a traditional leveraged loan, which has a number of lenders. There have been recent attempts to "ETF-ize" the sector, but the single-lender nature of many loans makes the underlying assets very illiquid. Using a liquid vehicle like an ETF is little more than using a band-aid to change a structural feature of the private markets.

While we were skeptical of the value of the private credit markets in their early days, the expansion, size, and broad adoption have led us to conclude that private credit can have a place in fixed-income portfolios. That place is not to supplant the traditional diversifying effects of high-grade long-term bonds, which provide strong returns into economic slowing, but rather to generate higher levels of income over longer time frames. From a portfolio construction standpoint, private credit today can take the place that a high-yield allocation did five or ten years prior. By implication, however, the sector does represent an added portfolio risk, not a "free lunch" diversifier. Credit risk in the sector is real and has not been tested through a full cycle.

CONCLUSIONS

Janney's interest rate outlook for 2025 is largely benign. With a strong private sector economy, we anticipate that the Fed will be in a position to cut rates only twice in the new year. Longer-term interest rates at a 4.20% 10-year Treasury are fair in relation to this outlook, though domestic fiscal policy and political decisions could skew U.S. rates to the upside of our base case. One way to reduce the risks of U.S. fiscal adventurism affecting bond portfolios is to overweight foreign developed market bonds. When it comes to other sectors, both IG and HY credit are at best a "neutral," as tight spreads battle with strong fundamentals for dominance in the coming year. Agency MBS remain attractive and, to a lesser degree, so too are tax-exempt municipals. Finally, we have market structure changes with the advent of private credit, which now appear durable after two years of uncertainty. Stay nimble, think long-term, and let income lead the way through uncertainty.

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Overweight: Janney ISG expects the target asset class or sector to outperform the comparable benchmark (below) in its asset class in terms of total return.

Marketweight: Janney ISG expects the target asset class or sector to perform in line with the comparable benchmark (below) in its asset class in terms of total return.

Underweight: Janney ISG expects the target asset class or sector to underperform the comparable benchmark (below) in its asset class in terms of total return.

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Asset Classes: Janney ISG ratings for domestic fixed income asset classes including Treasuries, Agencies, Mortgages, Investment Grade Credit, High Yield Credit, and Municipals employ the "Barclays U.S. Aggregate Bond Market Index" as a benchmark.

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