Pallas Perspective

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2025 Kicks Off Positively

As the year turned, financial markets have had the opportunity to reassess two strong years of U.S. equity market performance, emergence of artificial intelligence (AI), a key investment theme across semiconductor chips, software, data centers and power generation. Other variables have included relative underperformance of small cap and international equities, volatility in the bond market and rapid changes in expectations for interest rate policy. In addition, markets are handicapping policies of a new U.S. administration with potentially broad reaching changes in regulation, tax policy, and foreign trade relationships.

With January closing out, the financial markets have not disappointed with strong returns being generated in equities and positive returns in fixed income following a weak fourth quarter of 2024 due to rising interest rates. Looking beneath the surface of the indices, a classic January effect may be taking place with relative underperformers in 2024 performing better relative to the outperformers of the past two years, with value stocks outperforming growth stocks and developed international stocks outperforming U.S. equities.

While it is early to say that this trend will be sustained for the rest of the year, this past week's market turmoil, caused by the release of a potential alternative to U.S. dominance in AI with the success of Chinese start-up DeepSeek, does bring home the merit of investment diversification. It is too early to definitively say whether DeepSeek will usher in a major change to the previously held expectations for the build out and utilization of AI in the near term, but as with the evolution of past technologies including personal computers and the internet, the competitive landscape and ultimate winners will likely change and may differ from the perceived winners in the early stage of development. Thus again, the merit of diversification even when investing in a clear secular trend.

3 Noteworthy Insights in 2025

- **Aggressive Start to the year in January** - From a historical market perspective, as January goes so does the rest of the year. This positive indicator seems particularly relevant this year as the U.S. economy is seeing strong growth (US GDP growth came in at a robust 2.4% for 2024) with more growth projected, positive earnings growth is broadening out beyond the concentration in technology, and business sentiment is high. However, the very strong market performance for January may be difficult to sustain consistently throughout the year as stocks will need to see their underlying businesses grow into expectations that are elevated given high valuations relative to history.
- **Diversifiers Add Value** - In the current environment, diversifiers can add value. Over the last 5 years and more importantly in 2022 one of the disappointing features of asset markets has been the lack of diversification from bonds. Investors should take relief that in January we saw bonds act as a ballast in their portfolios along with real assets. On the worst drop for equity markets last week, when the SP500 fell by 1.7% bonds (especially longer duration bonds) delivered positive returns with long bond adding ~1%. Other areas of diversification for consideration include private markets. Valuation for private equity investments for instance are in-line with their long average at a time when public market trade near an all-time high.
- **Equity markets aren't just about Mag-7 and tech** – As we wrote earlier a good feature about 2025 has been the broadening of market with both Value and international markets outperforming the Mag-7 and growth stocks. In fact it was noteworthy that as the market fell 1.7% on Monday January 27, more than 300 of the 500 stocks in the S&P 500 Index rose that day, a feat which has never happened in the nearly 70-year history of the index.*

At Pallas Capital Advisors we take a balanced view to investing and are diligent in investment diversification to meet the long-term goals of our clients.

*State Street Global Advisors as of Jan 27, 2025.