James Investment Research, Inc.

Market Commentary

May 2025

Key Insights

- **Market Recovery and International Outperformance:** After a tumultuous start following "Liberation Day" tariff announcements, markets staged a significant recovery in the latter half of April.
- **Trade Policy Evolution:** The month began with President Trump's April 2nd announcement of "reciprocal" tariffs. This triggered the S&P 500's worst two-day performance since March 2020. By April 9th, Trump announced a 90-day pause on higher-level reciprocal tariffs to allow for negotiations, though China remained excluded and saw its tariffs increased to 145%.
- **Sector Rotation and Style Shift:** Information Technology (+1.62%) led U.S. sectors while Energy (-13.65%) significantly lagged as oil prices fell 18.5% amid tariff worries and increased OPEC+ supply.

Monthly Recap

It was a tale of two markets in April. U.S. market turmoil continued in the first half, as markets were whipsawed by tariff-related trade concerns, with the S&P 500 declining 0.68% and the tech heavy Nasdaq Index gaining 0.85%. Small caps fared worse, with the Russell 2000 Index falling 2.31%, confirming the domestic-focused equity segments suffered more from tariff concerns.

A significant style rotation became evident in April, with Growth outperforming Value across all market capitalizations. The S&P 500 Growth Index gained 2.23% while the S&P 500 Value Index declined 3.57%, a remarkable 5.8 percentage point spread. The S&P 500 Equal Weight Index's 2.29% decline further indicates that market breadth remained challenged, with gains concentrated in larger growth-oriented companies. The Bloomberg Magnificent Seven Index rose by 0.59%.

The month began dramatically with President Trump's April 2nd announcement of his "reciprocal" tariff package, which triggered sharp market declines. However, sentiment improved after Trump announced a 90-day pause on higher-level reciprocal tariffs on April 9th, though China remained excluded and instead saw tariffs increased to 145% (prompting Chinese retaliation with 125% tariffs on U.S. goods). Tensions remained high but showed signs of potential easing, with Treasury Secretary Bessent anticipating "de-escalation with China" and Trump providing relief on auto tariffs.

Performance within sectors revealed a significant rotation compared to Q1 trends. Information Technology led with a 1.62% gain, followed by Consumer Staples (+1.23%) and Communication Services (+0.75%). Energy suffered the steepest decline (-13.65%) as crude prices fell 18.5% amid tariff concerns and increased OPEC+ supply. Health Care (-3.70%) and Financials (-2.08%) also lagged.

In fixed income markets, performance was mixed. The Bloomberg US aggregate Bond Index gained 0.39%. The 10-year Treasury yield experienced its largest weekly increase since 2001 earlier in the month before declining 25 basis points by month-end to finish at 4.20%.

Commodities presented a mixed picture, with precious metals outperforming significantly. The S&P GSCI Precious Metals Index rose 4.81% as gold gained 5.3% in April, touching a new record high of $3,500/oz before finishing the month up 23.93% year-to-date. Energy commodities suffered substantial losses, with the S&P GSCI Energy Index plunging 16.25%.

Economic Challenges Emerge

April's market recovery occurred against a backdrop of emerging economic concerns. The U.S. economy contracted 0.3% in Q1, the first decline in three years, driven largely by a surge in imports as businesses

The James Investment Research Team


Brian Culpepper, CKA
President & CEO
Portfolio Manager


Fall Ainina, Ph.D., CFA
Director of Research
Vice President


Brian Shepardson, CFA, CIC
Vice President
Portfolio Manager


Trent D. Dysert, CFA
Associate Director of Research
Portfolio Manager

attempted to front-run tariff implementation. Consumer confidence fell to its lowest level since Spring 2020, while consumer sentiment dropped to its lowest point since July 2022.

Inflation concerns intensified substantially in February, with University of Michigan's 12-month inflation expectations holding at 4.3% (highest since November 2023) and 5-year expectations jumping to 3.5% (highest since 1995). The Conference Board's measure surged even more dramatically to 6.0% from 5.2%. In response to persistent inflation and economic uncertainty, markets pushed back expectations for Federal Reserve (Fed) easing, with the first rate cut now priced for July 2025 and only about 40 basis points of cuts anticipated for the entire year.

Economic growth concerns mounted as consumer sentiment deteriorated sharply - the Conference Board Index fell to 98.3 from 105.3, the steepest decline since August 2021, with expectations falling below the recession-warning threshold of 80. Supporting these concerns, February's Services Purchasing Managers' Index (PMI) contracted for the first time in over two years, existing home sales dropped 4.9%, retail sales weakened, and the Citi Economic Surprise Index turned negative, collectively suggesting a meaningful economic deceleration.

Despite these concerning indicators, a deeper analysis suggests that a single quarter of Gross Domestic Product (GDP) contraction does not necessarily signal an imminent recession. According to Fidelity, both consumers and businesses are facing headwinds but are coming from positions of strength. Corporate earnings are still expected to rise more than 10% this year, with profit margins remaining healthy despite recent pressures. The labor market, while showing early signs of cooling, remains relatively strong with job openings still above pre-pandemic levels.

Consumer spending has continued to grow at rates above pre-pandemic averages, buoyed by wage growth that has outpaced inflation for the past two years. This resilience in consumer spending is particularly significant as it represents approximately two-thirds of U.S. GDP. However, warning signs have emerged in manufacturing, where the U.S. ISM Manufacturing PMI New Orders Minus Inventories indicator has taken a sudden plunge, potentially signaling reduced production ahead. Small business uncertainty has also reached near record-high levels amid the flurry of tariff and policy announcements.

Credit markets have reflected this uncertainty, with spreads widening during April's volatility but remaining well below levels associated with past economic downturns. This suggests investors perceive elevated but not yet severe economic risks. As the second quarter progresses, market participants will closely watch whether the trade-related uncertainty translates into meaningful pullbacks in business investment and hiring that could accelerate economic weakness beyond what the first quarter data has shown.

Trade Policy & Economic Slowdown

President Trump's trade policy announcements significantly impacted markets, including plans for 25% tariffs on car imports starting April 2, with additional tariffs proposed for semiconductors and pharmaceuticals. These followed earlier tariff declarations targeting Mexico and Canada, though mixed signals emerged with mentions of a potential new China trade deal and European Union willingness to negotiate. Simultaneously, economic growth concerns mounted as consumer sentiment deteriorated sharply—the Conference Board Index fell to 98.3 from 105.3, the steepest decline since August 2021, with expectations falling below the recession-warning threshold of 80. Supporting these concerns, February's Services Purchasing Managers' Index (PMI) contracted for the first time in over two years, existing home sales dropped 4.9%, retail sales weakened, and the Citi Economic Surprise Index turned negative, collectively suggesting a meaningful economic deceleration.

Earning Strength & Corporate Resilience

According to FactSet, Q4 2024 delivered robust corporate performance, with 97% of S&P 500 companies having reported results. Among these, 75% posted positive earnings per share surprises, while 63% exceeded revenue expectations. The blended year-over-year earnings growth rate reached 18.2%, marking the strongest performance since Q4 2021. The S&P 500's forward P/E ratio stood at 21.2, considerably above both the 5-year average (19.8) and 10-year average (18.3), suggesting stocks remained relatively expensive despite recent market declines.

Topic of the Month: Europe's Market Resurgence – Fiscal Stimulus Driving Structural Shift

After underperforming U.S. markets for 17 years, European stocks have recently demonstrated notable strength. This resilience is particularly remarkable considering the heightened trade tensions and economic uncertainties that dominated April's headlines. While U.S. equity markets struggled, the STOXX 50 Index of European blue chip companies enjoyed a significant bounce, with the FTSE Eurofirst 300 reaching an all-time high.

Unprecedented Fiscal Spending as the Key Driver

The unprecedented fiscal spending by Germany and broader Europe has emerged as the game-changing factor boosting equity markets through multiple channels. Germany's €500 billion infrastructure fund and suspension of its "debt brake" for defense spending have ignited optimism about a structural shift in European growth. Investors now anticipate higher GDP growth—projected at +1.5% in Germany and +0.8% in the eurozone by 2030—driving stronger corporate earnings expectations and valuation expansions.

This fiscal pivot has directly contributed to a valuation re-rating for European equities. Previously trading at a 24% discount to global peers in 2024, European markets have narrowed to a 16% discount by early 2025, with room for further gains given the historical 10% average discount. The German DAX Index and the European STOXX 600 Index have surged to multi-year highs, partly due to previously low investor positioning and attractive entry points.

The earnings outlook has improved significantly as well. Increased public spending is expected to lift earnings-per-share (EPS) for European firms by approximately 7% annually over the next decade, potentially outpacing the S&P 500's projected 6% growth. Sectors like defense, infrastructure, and industrials stand as direct beneficiaries of these fiscal packages.

Valuation Advantage Now Gaining Attention

While the valuation discount between European and U.S. markets has persisted for years, the fiscal catalyst has finally brought this long-standing value opportunity into focus. According to Bloomberg, European equity markets have been trading at a discount to U.S. markets for years, but the gap reached a record 40% forward price-to-earnings (P/E) valuation discount, creating a compelling case for global investors seeking relative value once the economic growth outlook improved.

The latest Bank of America Global Fund Manager Survey revealed a startling swing toward European exposure, with respondents' European weighting rising by the most in any month since 2015 and by the second most ever. This rotation began even before the April market volatility, suggesting that investors were already repositioning toward international markets as U.S. exceptionalism showed signs of waning. Most notably, this shift has occurred despite investor surveys earlier in the year showing extremely low expectations for European stocks, with only 8% of participants at Goldman Sachs' Global Strategy Conference in January expecting Europe to be the best-performing market in 2025.

Bond Market Spillover and Growth Expectations

The fiscal expansion's impact extends beyond equities to the bond market, where a sell-off in German bonds (10-year yields rose 30 basis points in a day) has made equities more attractive relative to fixed income. These higher yields also reflect expectations of improved inflation and growth prospects for the region.

The spending shift, coupled with plans for deregulation and reduced bureaucracy, could potentially catalyze a decade-long bull market for European equities, with annual returns projected at approximately 10% versus around 7% for U.S. stocks. Capital repatriation and reduced dependence on U.S. markets may further support the euro and regional equities.

Economic Challenges Remain

Despite these positive developments, European economic fundamentals present a mixed picture. Germany, Europe's largest economy, continues to struggle with declining business sentiment. Both the IFO and ZEW surveys of German business sentiment suggest deepening pessimism.

Trade tensions with the U.S. present additional challenges. Trump's tariff policies have sparked concerns over Germany's competitiveness issues, while simultaneously driving significant gains in European defense stocks amid expectations of increased military spending. However, Europe's fiscal response has reduced reliance on exports and trade surpluses, fostering domestic demand resilience. Some analysts argue that any trade-related sell-off could present a buying opportunity.

Policy Divergence and Currency Effects

The dollar's decline has supported international market outperformance. Unlike previous periods when the dollar weakened amid improving risk appetite, this decline occurred during rising global uncertainty - suggesting a potential longer-term shift in currency markets that could continue to benefit European equities.

Monetary policy expectations have shifted as well. Markets now anticipate less aggressive Fed rate cuts in 2025, potentially narrowing the interest rate differential between the U.S. and Europe. This could further support European currency strength and equity market performance.

Structural Historical Context

It's worth noting that European outperformance isn't unprecedented. According to Bloomberg, historical analysis shows that prior to the 2008 financial crisis, European markets actually outperformed U.S. equities. From 1970 to 2007, U.S. markets underperformed Europe in 21 years and outperformed in 17 years. However, since 2008, this trend reversed dramatically with the U.S. outperforming Europe in 13 of 17 years. This suggests that market leadership can shift over extended periods, and the recent European outperformance may potentially signal a longer-term trend reversal.

Strategic Implications for Investors

The recent outperformance of European stocks raises important questions about portfolio positioning. While U.S. markets have dominated global returns for over a decade, April's performance suggests we may be witnessing an inflection point in relative performance.

For investors, the value proposition of European equities appears compelling given the combination of substantial fiscal stimulus and reasonable valuations, though structural challenges remain. European markets have historically lacked the concentration of high-growth technology companies that have driven U.S. outperformance, with only 8% of Eurozone earnings coming from fast-growing sectors compared to 35% in the U.S.

Nevertheless, the combination of government spending initiatives, potential dollar weakness, and the prospect of improving economic conditions as trade tensions eventually ease, creates a strong case for increasing international exposure. While the retreat from U.S. exceptionalism may not proceed in a straight line, April's market action suggests that global diversification may once again prove valuable after years of U.S. dominance.

Conclusion

April 2025 marked a pivotal moment for global markets as the initial shock of trade policy shifts gave way to a more nuanced investor response. While U.S. markets struggled to regain their footing, international markets -particularly in Europe - demonstrated remarkable resilience despite underlying economic challenges. The rotation from defensive to growth-oriented investment factors suggests investors are looking past immediate concerns toward potential resolution of trade tensions later this year.

However, significant risks remain on the horizon. The July 8th expiration of the 90-day tariff pause looms large, creating potential for renewed volatility if substantial progress in trade negotiations isn't achieved. Meanwhile, early economic indicators point to a slowing U.S. economy, with the first-quarter GDP contraction raising concerns about potential recessionary pressures later in 2025.

For investors, the key takeaway from April's market action is the renewed importance of global diversification after years of U.S. market dominance. The significant outperformance of international markets, particularly in Europe, suggests that the extreme valuation gap between U.S. and foreign equities may finally be driving a reversion in relative performance. Whether this represents a temporary correction or the beginning of a more sustained trend remains to be seen.

JAMES
INVESTMENT RESEARCH, INC.

P.O. Box 8 Alpha OH 45301 | (888) 426-7640 | info@jamesinvestment.com