WESTEND Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

Q2 2024

Opportunities for Offense and Defense

We see opportunities as late-cycle growth persists in 2024, but slowing growth and elevated sentiment also warrant caution.

SUMMARY

- Narrowly driven equity markets rose in Q2, buoyed by sentiment and concentrated profits, but we also see economic deceleration.
- While inflation is easing, we see monetary policy remaining restrictive even when the Fed begins initial interest rate cuts.
- We see opportunities for absolute and relative returns through participation in equity market upside and risk management.
- We still see an attractive risk/return profile in fixed income.

Q2 2024 REVIEW

After a brief pull-back early in the quarter, the U.S. stock market continued this year's strong-but-narrowly-led rally, with the S&P 500 Index returning 4.3%. The gains primarily were driven by a handful of mega-cap tech and AI-related stocks that are part of the so-called Magnificent 7 within the mid-phase Information Technology, Communication Services, and Consumer Discretionary sectors. Only three of the eleven GICS sectors outperformed the S&P 500, and six sectors actually had negative returns, with economically sensitive early-phase sectors lagging most. Year to date, only two sectors have outperformed the S&P 500.

Market Gains Still Narrow
Only two of eleven GICS sectors outperformed the S&P 500 YTD.

This weak performance across so many U.S. equity sectors, and especially more economically sensitive sectors, is consistent with late-cycle economic conditions, in our view. The second quarter saw slowing trends in various economic data, including consumer readings, which had been fairly resilient for much of this cycle. For example, the unemployment rate reached 4% for the first time since January 2022; real disposable personal income growth slowed in May to just 1.1% year-over-year versus 3.8% at the end of 2023; and growth in consumer spending on discretionary categories we track has fallen to about half that of spending growth for necessities. Despite signs of activity slowing and decelerating inflation readings, the Fed has yet to begin anticipated rate cuts, and markets now appear to expect only about 45 bps of cuts in 2024, roughly a third of what was expected at the beginning of the year.

Treasury yields rose slightly in Q2, and investment grade corporate spreads ended the quarter little changed, leaving most bonds with very modest, income-driven returns, though high-yield credit outperformed. Bond returns generally remain negative year-to-date, outside of high yield, though returns have improved since late April.

Internationally, emerging markets (EM) in Asia outperformed as Chinese stocks rebounded amid some signs of stabilization in consumption and fixed investment, alongside of additional, yet minor, policy supports. Other EM regions were among the worst-performing equites globally. Developed markets also lagged as European equities posted negligible returns amid political uncertainty and softer than expected economic data, while Japan underperformed as idiosyncratic factors like individual factory shutdowns weighed on growth.

OUTLOOK

Cautious Optimism
Economic and market cycles could persist into 2025, but backdrop warrants caution.

Overview: Late-cycle economic conditions persist in the U.S., with markets buoyed by sentiment and narrow pockets of strength amid signs of broader economic slowdown. **We remain optimistic that the cycle can grind on through 2024**, and potentially beyond, though we believe **slowing growth alongside elevated sentiment warrants caution**. While the Fed could begin moderate rate cuts this year, we see few, if any, near-term catalysts for the start of a new cycle in the face of still-restrictive monetary policy and limited slack in the economy. Internationally, we still see headwinds for Europe and economically sensitive emerging markets, while relatively positive economic trends in Japan remain attractive.

Across portfolios, we are **seeking to capture select opportunities and participate in potential market upside, while maintaining defensive allocations** that we expect should outperform in the event economic conditions deteriorate. We also continue to see positive risk/return characteristics for fixed income in balanced portfolios, given current yields and our economic and interest rate outlooks.

U.S.: A range of measures suggest economic activity continues to slow, and **key supports for recent growth appear likely to contribute less going forward**. The annualized growth of real GDP slowed to just 1.4% in Q1 (reported in Q2) compared to a recent peak of 4.9% in Q3 2023. Meanwhile, contributions to growth from the U.S. consumer, fixed investment, and government spending—all key supports for growth in recent quarters—appear poised to decelerate.

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The consumer, typically the largest contributor to U.S. GDP growth, appears played out. Drivers of higher consumption include diverting savings to spending, taking on debt, or increasing income. Our analysis shows that excess savings accumulated during the pandemic, which supported consumption in the recovery, has been depleted. A material decline in the savings rate seems unlikely, as the most recent reading of 3.9% in May is below the lows seen in the last expansion. Measures of household leverage do remain low, but elevated interest rates and tight lending standards are headwinds for additional debt-fueled consumption.

Consumers Low on Fuel
Low savings and weaker job growth may restrain spending.

Income growth is arguably the most sustainable driver of consumption growth, and job growth is a key driver of aggregate income growth. While nonfarm payrolls have added an average of about 250,000 per month this year (similar to last year), gains have been narrowly driven by a rebound in health care, education, and hospitality jobs, and the Bureau of Labor Statistics' separate Household Survey shows overall employment has *fallen* by an average of 20,000 per month this year. **Looking forward, low (though rising) unemployment and the recovery in labor market participation may limit income growth from further job creation.** Hourly wage growth, meanwhile, is still above its long-term average, but has decelerated steadily since early 2022.

Growth in government spending and fixed investment (partly supported by government spending) have remained fairly robust, but we see both decelerating within our 6-to-18-month investment horizon. As spending ramped up from major legislation like the CHIPS Act and the Inflation Reduction Act (both passed in 2022), it had a notable impact on growth in 2023. Looking forward, these should drive *ongoing* spending more than *increases* in spending. We do not have specific predictions for winners in the 2024 elections, but **a likelihood of divided government or very narrow single-party control in 2025 reduces the prospect of major new spending bills**, in our view.

Monetary policy is unlikely to be a near-term panacea for economic growth or markets. Given lags in the impact of monetary policy on the economy, we believe **the Fed's recent rate hiking cycle remains a headwind to growth**. We expect continued disinflation can provide the Fed with flexibility in managing rates. However, even the 4-6 cuts that were initially expected this year—let alone the 1-2 cuts which now seem more likely—would still leave real interest rates restrictive. Absent a sharper-than-expected pullback in growth, we believe the Fed is unlikely to cut rates enough to kick off a new economic cycle.

Market sentiment is disproportionately high, in our view, given economic conditions. Measures of market sentiment, including valuations and investor survey data, show limited bearishness. We believe elevated measures of broad corporate profits, which have been above-trend post-pandemic, are a key driver of this elevated sentiment. However, profitability has been lifted in recent quarters by narrow strength from the Magnificent 7 and similar stocks in mid-phase, tech-related sectors. Beyond this narrow strength, our analysis indicates that aggregate profit growth has largely stalled. Further, consensus expectations for future profit growth rely heavily on economically sensitive sectors, yet, the Citi U.S. Economic Surprise Index is nearing a 2-year low, suggesting the **economic assumptions underpinning profit expectations may have gotten ahead of reality**.

Given the economic and market backdrop, we believe caution is warranted. We retain a material **overweight of late-phase, defensive U.S. sectors** across portfolios. Our largest sector overweight is Health Care, which we believe is experiencing a durable earnings recovery following a post-COVID slowdown. We continue to **avoid most early-phase, economically sensitive U.S. sectors**, but we do, however, see a sector-specific, earnings-driven opportunity in Financials amid a recovery in investment banking and capital markets activity.

We maintain **significant exposure to mid-phase sectors**, which offer economic sensitivity but are less vulnerable to cyclical downturns, in our view, than early-phase sectors. This includes exposure to tech-related companies that have driven recent earnings growth and market gains. However, we see a risk that elevated earnings expectations for AI-linked mega-caps may be overestimating the durability of the capex cycle. Our research indicates that tech capex upswings historically last 12-24 months, and we are more than a year into this cycle.

International: We see little chance of a global rebound in growth and are actively underweight international equities in global portfolios. Monetary policy remains restrictive across most of the developed world (outside of Japan). In Europe, employment and GDP growth have slowed to below-average levels. Europe's cyclical sensitivity, coupled with limited government stimulus and little pent-up household savings, lead us to believe that **materially looser monetary policy is required before Europe's economy will be able to re-accelerate**. We are also underweight emerging markets, given our global economic outlook.

Japan is a positive international outlier, in our view, thus developed Asia is our one international overweight in global portfolios. **Japan's monetary policy remains accommodative**, despite modest moves toward normalization, and export growth appears to be widening out beyond transportation, with strength in areas like electrical equipment.

Fixed Income: We retain a modest overweight of fixed income in traditional balanced portfolios, given our economic outlook and the attractive risk/return profile we see for bonds at this point in the cycle, especially relative to equities. While long-term interest rates could remain volatile in the near term, **we see more potential for a decline in rates than risk of upside**, given late-cycle conditions, slowing inflation, and a likelihood of some initial Fed rate cuts. At current yields, longer-term Treasury bonds could see total returns in the high teens over the next year with as little as a 100-basis point decline in yields, while an equivalent rise in yields would suggest only single-digit downside.

For corporate bonds, credit spreads at extremely tight levels present risk to returns in the event of market volatility or sustained economic weakness. Thus, within fixed income allocations, we are focusing corporate exposure in shorter maturities, where lower duration reduces the negative return impact of a potential widening of credit spreads.

WestEnd Advisors Investment Team | July 1, 2024

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