WESTEND Advisors
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An Easing Cycle Amid a Broadening Market Cycle

As the Fed starts an easing cycle, tight monetary conditions and their impacts could linger and signs of slowing growth abound. Still, late-cycle conditions have supported attractive market returns for two years, and we continue to see a mix of opportunities and risks as market leadership broadens.

SUMMARY

- U.S. equities continued to rally in Q3, with a shift to broader sector leadership as shares of large, AI and tech-related firms lagged.
- As the Fed continues with its new easing cycle, we see continued signs of economic slowdown and lingering headwinds from tight monetary policy, but not imminent recession.
- While late-cycle conditions present risks, they can also sustain attractive market returns for extended periods, in our view.
- Given our current outlook, we have positioned portfolios with a balance of defensive and select economically sensitive exposures.

Q3 2024 REVIEW

As late-cycle economic conditions extended through Q3 2024, equities continued to rally. In the U.S., the S&P 500 returned 5.9% in Q3, and has now returned 22.1% year-to-date. However, there was a notable shift in the makeup of S&P 500 returns in Q3. Coming into Q3, stock market leadership had been very narrow, with Information Technology and Communication Services so dominant that no other sector outperformed the S&P over the first half of the year. In Q3, we saw a broadening of market leadership. Information Technology and Communication Services corrected on a relative basis, while eight other of the eleven GICS sectors outperformed the S&P 500. The interest rate-sensitive Utilities and Real Estate sectors led the market as rates fell in Q3, likely in anticipation of the Fed's rate cut.

A Broadening Market
Eight sectors outperformed the S&P 500 in Q3 vs. only two in the first half of 2024.

In September, the Federal Reserve (Fed) finally began a long-awaited easing cycle with a 50-basis point cut as economic data, including a clear softening of the labor market, provided some confirmation signals of slowing growth. The Fed cited a shift in the balance of risks, with **diminished upside risk to inflation and increased downside risk to employment**. For August, the Fed's preferred measure of inflation, the core Personal Consumption Expenditure (PCE) price index, showed a 2.7% year-over-year increase, down from 3.8% last August. Meanwhile, payroll gains averaged 116K per month in the first two months of Q3, versus 147K per month in Q2 and 267K per month in Q1, and the unemployment rate was up to 4.2% in August from 3.7% at start of the year.

More broadly, the trend in U.S. real GDP has remained moderate but resilient. The current revised figure for Q2 stands at a 3.0% seasonally adjusted annual rate, after dipping to 1.6% in Q1. While consumption and government spending have remained fairly steady contributors, inventory build boosted the latest figure by over a percentage point.

International equities generally outperformed the U.S. in dollar terms, as the dollar weakened almost 5% versus a trade-weighted basket of currencies. Asian markets led globally, with Chinese shares seeing a sharp boost late in Q3 after the government announced a range of monetary and fiscal stimulus. While Japanese and European shares underperformed in local currency, U.S. investors benefitted from rebounds of about 12% in the yen and 4% in the euro, respectively.

Fixed income performed roughly in line with equities in the U.S. in Q3 as interest rates fell. The yield on the 10-year Treasury was down 62 basis points to 3.78% as markets looked toward the Fed's September rate cut amid slowing inflation and economic conditions. Corporate yield spreads widened modestly, but corporate bond returns generally edged out Treasury securities due to their higher yields.

OUTLOOK

Opportunity and Risk
Amid late-cycle risks, we are pairing defensive exposure with select economically sensitive allocations.

Overview: Late-cycle economic conditions persist in the U.S. and globally. U.S. economic growth is trending below its long-run average (despite an uptick in Q2), and a mix of **economic data is showing confirmation signals of continued slowing**, in our view. While the Fed's new easing trajectory is a positive, it is not a silver bullet, and policy remains tight with the potential for lingering negative impacts to growth. International economies also still face material headwinds from monetary policy and other late-cycle challenges ranging from slowing job growth in Europe to a real estate hangover in China.

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We see no likely catalyst for a sustained near-term reacceleration of economic growth, but neither do we see imminent recession, despite elevated risks. History shows that late-cycle economic conditions can last for extended periods and sustain attractive broad market returns for both equities and fixed income, as illustrated by last year and 2024 year-to-date. Looking forward, we believe **a balance of defensive and select economically sensitive exposures that could benefit from secular or cycle-specific tailwinds offers the potential for attractive returns while managing risks**.

U.S.: As both economic growth and inflation have cooled this year, the Fed has been a key investor focus. Hopes for an easing cycle (now begun) have helped support equities and push down interest rates. The degree of cutting expected through next year, however, would still leave rates restrictive, in our view. The median estimate of FOMC members for the level of the Fed Funds rate at the end of 2025 is 3.4%, and they expect core PCE inflation to fall to 2.2%, suggesting the ***real* Fed Funds rate could still be north of 1% at the end of 2025**.

Meanwhile, **the Fed's new easing does not mean the impacts of prior tightening are over**. Many corporations issued or refinanced debt at exceptionally low rates before the recent tightening cycle, and their debt servicing costs could still increase materially as they refinance issues maturing over the coming year. Similarly, residential and commercial mortgage rates and the financing hurdle rate for fixed investment are also above trend levels from the past cycle. However, both corporations and consumers do appear to have a reasonable amount of borrowing capacity that could help sustain moderate growth.

The **U.S. consumer remains on solid footing**, but has limited capacity to *accelerate* spending from here, in our view. The post-COVID spending recovery was fueled by excess savings that is now effectively depleted, and the personal savings rate, which spiked above 30% during COVID, has normalized around 5% over the past year. That leaves aggregate consumer spending growth largely dependent on job growth and wage gains. Job growth is not only slowing, as previously noted, but has been exceptionally narrow in 2024, driven primarily by health care and government.

Late-Cycle Love Can Linger
Slower economic growth can still yield attractive market returns.

With this backdrop, we see no catalyst for a near-term economic reacceleration, but we believe a period of slow-to-moderate growth could last into 2025 or beyond. This, in turn, could support continued earnings growth and equity gains. Returns thus far in 2024 have been driven by a mix of earnings growth and valuation expansion. For 2025, S&P 500 earnings estimates from FactSet currently anticipate 15.1% growth. That may prove optimistic if economic growth slows, but we expect even a reduced pace of **earnings growth could support healthy equity returns next year** without the need for further valuation expansion.

Current **U.S. sector positioning** across our portfolios balances return opportunities we see in select early- and mid-phase sectors, with an overweight of late-phase, defensive sector exposure, given the broader risks to economic and market performance. Amid continued economic growth and declining interest rates, we have moved to an overweight of Financials with an emphasis on capital markets firms, which we see benefiting from a rebound in investment banking activity. We have also added exposure to the Real Estate sector, where we expect accelerating funds from operations for REITs after earnings declines earlier this year. **We continue to avoid other highly cyclical, early-phase sectors** like Industrials and Materials.

We retain a significant-but-underweighted allocation to mid-phase sectors in aggregate. After multiple quarters of strong outperformance prior to Q3, the Information Technology and Communication Services sectors carry lofty valuations, but also face the prospect of decelerating earnings growth in our 6 to 18-month investment horizon. The largest companies in these sectors are also in the midst of a heavy investment cycle to build out AI infrastructure, and our analysis indicates their performance can become challenged by accelerating capex growth while earnings growth is decelerating. These sectors' **valuations present risks**, in our view, if financial results undershoot elevated investor expectations or the near-term benefits from AI underwhelm.

With respect to the upcoming **U.S. elections**, as noted in our recent 2024 Election Preview commentary, broad market **returns in election years tend to be driven more by the economic backdrop than politics, regardless of the election outcome**. This year's Presidential race is neck-and-neck, but we see the two most likely outcomes as a Harris win with divided government or a Republican sweep. This creates uncertainty around key issues like trade and tax policy, but **major policy shifts could be difficult to achieve in either scenario**. We believe it is premature to position around the uncertain outcome.

International: As in recent quarters, most major economies are slowing and still face late-cycle challenges. In global portfolios, we are underweight Europe, where we do not expect recent rate cuts to provide an immediate boost to growth, and emerging markets, including China, where headwinds persist and our analysis suggests its stimulus will have limited near-term impact on growth. We do retain an overweight of developed Asia, where we see Japan's relatively stimulative monetary policy and defensive characteristics as attractive.

Fixed Income: Although current interest rate levels already seem to reflect continued Fed easing toward a neutral policy rate, we see the current absolute level of interest rates and asymmetric risks tilted toward the downside for rates as supportive of attractive bond returns. If economic growth continues to slow and the Fed moves toward more stimulative monetary policy, we would expect rates to move lower across the yield curve. Further, as inflation has eased, **the correlation between equities and fixed income has moved lower, supporting fixed income's potential to offer protection in a risk-off environment**.

Given these factors and ongoing macro risks, we maintain a modest overweight of fixed income in traditional balanced strategies. Within fixed income, we favor long-maturity Treasury exposure, given limited upside risk to interest rates and low corporate spreads. We have focused corporate exposure in shorter maturities, which have yields similar to long-term corporates, but less duration risk if spreads widen.

WestEnd Advisors Investment Team | October 1, 2024

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