Economic and Market Commentary

December 16, 2024

WESTEND Advisors

A VICTORY CAPITAL® INVESTMENT FRANCHISE

2024 Year-in-Review
Concentrated Risks, Broadening Opportunity

The first half of 2024 saw a continuation of various trends, including slower economic growth, easing inflation, tight monetary policy, and unusually narrow equity market leadership. More recently, several regime changes, including the start of Fed rate cuts, a reduction of political uncertainty, and the broadening of market leadership may offer potential opportunities for active investors in a mature but ongoing economic cycle.

As we near the end of 2024, we look back at some of the year's key economic and market developments, as well as how key portfolio allocation decisions evolved along the way (see call-out boxes).

2024 YTD REVIEW (through December 13, 2024)

- Entering 2024, we saw either a deterioration of growth with increased risk of recession or a "soft landing" as likely, but we did not see fuel for a sustained reacceleration of growth.
- Real U.S. GDP growth did slow in Q1 2024, but has rebounded to a healthy pace, particularly for a mature economic cycle.
- Inflation continued to slow in 2024, and the Fed began a long-awaited rate-cutting cycle in September, though easing disinflationary pressures and signs of labor market resilience have reduced expectations for the pace of future cuts.
- Amid continued economic growth, the U.S. equity market extended strong 2023 performance into 2024, largely driven by narrow market leadership from a handful of AI and tech-related stocks in the first half of the year, but broader leadership since.
- This broader S&P 500 sector leadership has included sectors like Consumer Discretionary and Financials, as Info. Tech. and Comm. Services faced valuation concerns, lower earnings growth expectations, and regulatory scrutiny.
- International economies continued to lag the U.S. and international markets underperformed in the first half, though a rebound in emerging Asia helped close the gap somewhat in Q2 and Q3 as China boosted its economic stimulus and U.S. election uncertainty increased.
- The U.S. election results removed the risk of a contested election and prolonged post-election upheaval, while also seeming to lift economic and investor sentiment as anticipated policy impacts may skew toward growth in the near-term, despite potential headwinds from tariffs, fiscal, and immigration policy.

1ST HALF 2024: CONTINUATION OF TRENDS

The global economy continued to exhibit late-cycle conditions in the first half (1H) of 2024. Real economic growth in most major countries and regions, outside the U.S. and Japan, remained below-average versus the past decade, and U.S. GDP decelerated for a second consecutive quarter in Q1 before partially rebounding in Q2. The Federal Reserve (Fed) was signaling three rate cuts in 2024 at the start of the year, and market hopes for as many as 5-6 cuts over the year faded as growth persisted, with notable resilience in consumers and the labor market, and disinflationary gains slowed. Throughout 1H, we saw an increasing probability that late-cycle economic growth could continue in the U.S., and we made incremental portfolio adjustments to reflect our evolving outlook.

Early February 2024

Added new U.S. Financials allocation, reduced late-phase defensive sector exposure across our ETF portfolios. Reduced fixed income overweight in balanced strategies.

From a market perspective, 1H 2024 was also a continuation of 2023 in many ways. The global stock market extended a steady rally, led by the U.S., where the S&P 500 Index returned 15.3% with limited bouts of volatility in 1H 2024. Markets remained highly concentrated, however, with widely touted "Magnificent 7" stocks driving S&P 500 strength. While various U.S. sectors had strong absolute performance, supported by both earnings growth and valuation expansion, market leadership was so concentrated that only two S&P 500 sectors outperformed, Information Technology and Communication Services. Those two sectors more than doubled the returns of the next closest sectors in 1H 2024. This extremely concentrated market made it difficult for any active equity manager with a diversified portfolio to outperform. It also intensified sector concentration risk that had been building in recent years in the

April 2024

Expanded U.S. Financials allocation with targeted Capital Markets exposure and further reduced late-phase, defensive U.S. sector exposure across our ETF strategies.

U.S. By mid-2024, the combined weight in the S&P 500 of Information Technology and Communication Services exceeded 40%, a level last reached at the end of the Tech Bubble in 2000.

International markets generally continued to underperform in 1H 2024, in U.S. dollar terms, as the U.S. economy outpaced most other major economies and the U.S. dollar appreciated. China did start to rally and outperform in Q2 amid some signs of stabilization in consumption and fixed investment, alongside of additional, yet minor, policy supports. Japan's economy remained a positive outlier, in our view, but its equity markets were volatile, outperforming in Q1 but turning negative in Q2.

In domestic fixed income markets, a modest rise in longer-term rates early in the year drove negative returns for most categories of bonds, with capital losses offsetting yields as expectations for Fed cuts re-aligned with Fed messaging. Corporate bonds outperformed Treasury bonds as credit spreads approached record lows amid reduced equity market volatility and an apparent increase in investor risk appetite.

2ND HALF 2024: U.S. REGIME CHANGE?

In the second half of 2024, we have seen notable shifts in certain economic, political, and market conditions in the U.S. What has not changed, broadly speaking, is our view that we are in a mature economic cycle. Early-phase, economically cyclical sectors like Industrials, Energy, and Materials have shown some of the weakest earnings growth year-to-date, and we see little fuel for a reacceleration to early-cycle economic growth. We do believe the U.S. has the potential to sustain late-cycle growth in the near-term, while international economic and market conditions remain less favorable, on the whole.

August 2024
Reduced mid-phase, tech-related U.S. sector exposure, added a new U.S. Real Estate allocation, and further increased Financials allocation across ETF strategies.

The U.S. equity market saw a crucial change in 2H 2024, as market leadership shifted and broadened out. From 2023 through 1H 2024, the Information Technology and Communication Services sectors led the U.S. market, partly driven by strong earnings growth and investor enthusiasm tied to AI-related stocks. However, as the Information Technology and Communications Services sectors became increasingly large weights in S&P 500, increasing investor concerns over valuations, an eventual slowdown in earnings growth, and regulatory scrutiny began to weigh on the sectors. In Q3, they underperformed all but one sector and market leadership began to shift among a range of sectors. Utilities and Real Estate led in Q3 as longer-term interest rates pulled back and the Fed finally launched its rate-cutting cycle. To date in Q4, two economically sensitive sectors—Financials and Consumer Discretionary—have outperformed alongside Tech. and Comm. Services. In our view, broadening market leadership offers significant opportunities for active investors.

The Fed's move to start cutting rates in September marked another regime change, following progress in bringing down inflation and some deterioration in labor market conditions. However, core CPI, which had been trending down for two years through mid-2024, has largely stalled in 2H, and the unemployment rate, which had been inching up since early 2023 leveled off in 2H. A lack of clear direction in the near-term for inflation and employment has fostered uncertainty over future monetary policy, which has helped push longer-term interest rates back up and weighed on fixed income returns in 2H 2024.

Political uncertainty around the U.S. elections also shifted in various ways in 2H. First, uncertainty increased as President Biden's debate performance in late June led to his withdrawal from the race, and a surge in support for the new presumptive Democratic nominee, Vice-President Harris, brought the race into a seeming dead heat. As the campaigns wore on, polls and betting market odds remained tight, providing little clarity on who might win, until tilting toward Trump in the final days of the race. Beyond uncertainty around who would win, Trump's victory also effectively removed the risk of a prolonged and contentious post-election fight over the results. It also brought, in our view, an incremental boost to investors' economic sentiment.

Leading up to the election, we had been analyzing potential risks and benefits for the economy, broad markets, and particular sectors from either a Harris or Trump win. With full GOP control, we see the balance of policy risks and sentiment impacts as incrementally positive in the near-term. Once the outcome was known, we implemented portfolio adjustments intended to help capture opportunities and manage risks we saw tied to the election outcome and broader macroeconomic trends.

November 2024, Post-Election
Added to Financials and Info. Tech. exposure, while eliminating Real Estate and Utilities exposure within the U.S. equity allocations of our ETF strategies. Reasserted a U.S. equity overweight in global portfolios. Eliminated fixed income overweight and reduced fixed income duration in balanced strategies.

A PEEK AHEAD

We look forward to providing more focus on our outlook in early January with our regular quarterly commentary and Macroeconomic Highlights pieces. Meanwhile, seeing how 2024 has progressed, we continue to believe the U.S. is in a mature economic cycle, with a mix of positive developments like healthy personal income and spending, but also challenges like a softer labor market. We believe the Fed remains on track for near-term rate cuts, which could lead to a re-steepening of the yield curve amid continued economic growth. Despite some potential policy headwinds to growth, we see the post-election balance of policy and sentiment impacts on the economy as likely to skew toward continued growth and dollar strength in the near-term. With elevated equity valuations across sectors, we expect earnings growth will be a key driver of returns in 2025, which could support another year of good equity returns, though a third year of 20%+ returns is historically unlikely. We continue to emphasize the U.S. in global portfolios and a mix of select economically sensitive exposures and defensive sectors within the U.S. across strategies. As always, we continue to evaluate the macroeconomic backdrop and stand ready to adjust portfolios as our outlook evolves.

WestEnd Advisors Investment Team | December 16, 2024

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