WESTEND
Advisors
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Economic and Market Commentary

Q4 2024

Extending Economic Cycle, Extended Valuations

Near-term U.S. economic risks have receded somewhat while market risks remain, in our view. For 2025, we believe continued late-cycle economic growth should provide select market opportunities, though managing risk from valuation and market concentration will be crucial.

SUMMARY

- U.S. economic growth remains relatively healthy, with consumers bolstered by rising incomes and household net worth.
- We expect high-single-digit or low-double-digit U.S. equity returns in 2025, driven by earnings growth rather than valuation.
- We believe a select mix of economically sensitive and defensive U.S. sector exposures is appropriate to help balance near-term opportunities and risks.
- Most international economies and markets face ongoing challenges, in addition to new uncertainty over U.S. trade policy.
- While elevated interest rates provide bonds with attractive yields, the potential for further steepening of the yield curve needs to be considered, in our view.

Q4 2024 REVIEW

Macroeconomic data suggest the U.S. economy continued to deliver solid late-cycle growth in Q4, following 3.1% real GDP growth in Q3. Consumption has remained a key driver of growth, while a downward trend in inflation and a modest upward trend in unemployment both stalled in Q4. The Fed continued the rate-cutting cycle it launched in September, while also seeking to dial back expectations for future cuts. The Fed's signaling, along with continued economic growth and election-related economic optimism, seems to have helped push up longer-term interest rates during the quarter.

U.S. stocks started Q4 with a continuation of strong returns that characterized most of the year, benefitting from an additional sentiment boost as investors seemed to take a positive view of the Republican sweep in U.S. elections. A mix of sectors drove a selloff in December, however, as diminishing expectations for the pace of Fed easing weighed on valuations for many economically sensitive and interest rate-sensitive sectors.

Overall, the S&P 500 posted a 2.4% return in Q4 and a 25.0% return for 2024 as a whole. Both valuation multiple expansion and, to a lesser degree, earnings growth contributed to the strength of full-year returns. Contributions from earnings growth for the year were largely concentrated in the year's four best-performing sectors: Communication Services, Information Technology, Financials, and Consumer Discretionary. These same sectors were also the only ones that posted positive returns in Q4.

Rising interest rates led most categories of bonds to post negative returns in Q4. Corporate bond returns generally held up better than Treasury bonds, thanks to their higher yields, shorter durations at a given maturity, and modest spread compression, but (outside of junk bonds) these yields were not sufficient to fully offset the negative impact of rising rates on returns. Treasury and mortgage-backed securities were among the worst-performing fixed income categories.

International economies continued to struggle relative to the U.S., and international markets turned down in Q4. Nearly every region posted negative returns in U.S. dollar terms, as the dollar rose an average of 7.7% against major currencies. Europe was the worst-performing major region amid negative economic surprises and political turmoil in various EU countries, as well as the threat of tariffs and challenging U.S. relations ahead. In Asia, China's recently announced stimulus measures were insufficient to boost markets, while Japan's relatively healthy economy and stimulative monetary policy helped support positive local-currency equity returns.

OUTLOOK

Mature But Resilient Economy
Consumer spending supported by rising incomes and household wealth should provide support for continued economic growth in the U.S.

Overview: We continue to see economic resilience amid a mature economy in the U.S. While various macroeconomic tailwinds are fading, GDP growth remains expansionary, driven by consumer spending supported by growth in personal income and household wealth, as well as government-influenced spending.

The labor market continues to grow, as layoffs and unemployment remain low, though hiring shows signs of slowing. Recent

disinflationary trends and slower job growth are likely to keep the Fed on track for rate cuts, in our view, though at a slower pace than was expected even a few months ago. This, in turn, could lead to a re-steepening of the yield curve amid continued economic growth.

If the economic cycle remains on track, U.S. stocks could be poised for another positive year in 2025, though history suggests a third consecutive year of 20%-plus returns is unlikely. Continued economic growth should support earnings growth, but we believe reduced economic risk has been at least partly offset by increased market risk as valuations have risen materially across most sectors in recent years. At the same time, risks from sector concentration have increased, as the Information Technology and Communications Services sectors have seen among the highest valuation increases and together now represent over 40% of the S&P 500. In this environment, we believe an emphasis of select economically sensitive U.S. sector exposures paired with a material allocation to more defensive sectors remains appropriate in equity allocations.

Shifting Risks

While some near-term economic risks seem diminished, elevated valuations and sector concentration present market risk.

For balanced portfolios, we believe the potential for the yield curve to steepen has increased upside risk to interest rates, which could dampen the return benefit of elevated yields for longer-term bonds, though fixed income should still offer defensive characteristics in the event that economic growth falls below our expectations.

The international picture stands in contrast to the U.S., with ongoing economic malaise and a market downturn in Q4 2024. Europe continues to face economic and geopolitical headwinds, while emerging markets face particular challenges from a lack of internal growth drivers and renewed dollar strength. Both developed and emerging countries face the risk of external shocks like the threat of U.S. tariffs. Overall, we see limited opportunities abroad, though Japan remains a relative bright spot, in our view.

U.S.: We believe near-term economic risks have diminished, and the U.S. economy has the potential to extend late-cycle growth through 2025. Year-end estimates aggregated by the Federal Reserve anticipate real GDP growth of 2.1%, on average. This is reasonable, in our view, given ongoing income growth and the buildup of household wealth that can support a propensity to spend. While real disposable personal income growth has slowed from pandemic-era levels, it remains slightly above the 2010-2019 expansionary average of 2.45% year-over-year. Further, surging equity markets and home values since 2022 have lifted consumer confidence and enabled households to reduce their savings rate. While we see little room for an *acceleration* of spending, we believe accumulated wealth and income growth can help sustain moderate consumption growth in 2025, notwithstanding further softening in the labor market.

Inflationary pressures have eased, but disinflationary trends also weakened late in 2024. With the labor market still on relatively solid footing, despite a slowing trajectory, the Federal Reserve has indicated it will likely cut rates less in 2025 than previously expected. This suggests monetary policy will remain moderately restrictive in the near-term, which further argues for an extension of late cycle growth rather than a material reacceleration of growth in the near-term. Meanwhile, potential policy shifts following the Republican election sweep could present a mix of headwinds and tailwinds for the economy, but we believe the balance of fundamental policy and sentiment impacts on the economy is likely to skew in favor of continued growth within our typical 6-to-18-month investment horizon. Other factors, including productivity gains or a resurgence in borrowing could also help support growth and extend the cycle.

For U.S. stocks in this mature economic environment, we anticipate that earnings growth could reach double digits again in 2025. Valuations, on the other hand, are near the high end of their historical ranges and are likely to be challenged, in our view, by interest rates remaining higher for longer, slowing economic growth, and monetary & fiscal policy uncertainty. Taking these together, we anticipate U.S. stocks could see high-single-digit or low-double-digit returns in 2025.

At the sector level, we expect leadership could continue to broaden out, and we see a range of opportunities and risks. The tech-related sectors that were boosted by enthusiasm for AI in 2024 now boast some of the highest sector valuations. While these sectors have begun to see some positive revenue impact from AI, we are mindful of the risk of disappointing elevated investor expectations in 2025. As such, we are currently underweight U.S. Information Technology across portfolios and have tilted our Technology exposure toward the Software industry, which we believe carries more palatable valuations alongside of consistent growth.

Select Opportunities

U.S. Financials should benefit from a steeper yield curve and increased capital markets activity, in our view, while Health Care and Consumer Staples offer earnings growth stability.

We believe the U.S. Financials sector should benefit from continued moderate Fed rate cuts, a resulting steeper yield curve, and a continued resurgence of capital markets activity. We are avoiding, however, certain other economically cyclical sectors, like Industrials and Materials, as well as the highly interest rate sensitive Real Estate and Utilities sectors in the U.S.

We have reduced defensive exposure as recession risk has diminished, but we believe the stable earnings growth potential of the defensive U.S. Health Care and Consumer Staples sectors remains attractive, given ongoing late-cycle economic risks.

International: The U.S. and Japan remain positive outliers in the global economy, in our view. In addition to relatively healthy economic growth and, for Japan, stimulative monetary policy, both have seen larger household wealth gains than Europe over the past two years, while China has actually seen household wealth decline. We believe these diverging wealth trends should help support future investment and consumption growth in Japan and the U.S.

The asset price and wealth declines in China represent a headwind to consumption that recent stimulus measures have seemed unable to address. Emerging markets, more broadly, tend to have commodity-linked economies that face significant risks from both slow global demand growth for commodities and pricing pressures tied to dollar strength, as well as the looming threat, especially for China, of U.S. tariffs.

Europe has seen improvement in inflation, a previous headwind, but the region also faces risks from tariffs and internal political uncertainty, while consensus expectations suggest unemployment will rise and wage growth will slow in 2025. While we do not necessarily forecast recession for Europe's major economies, we expect they are likely to underperform the U.S. within our investment time horizon.

Given the international backdrop, we have recently reasserted our overweight of U.S. equities in global portfolios, though we also maintain an overweight to Developed Asia, and particularly Japan.

Steep Prospects

With prospects for continued economic growth and a steepening yield curve, we have eliminated an overweight of fixed income in traditional balanced accounts.

Fixed Income: Over the course of 2024, shifting expectations for Fed rate policy, inflation, and economic growth have had a material impact on the U.S. Treasury yield curve. At the start of 2024, the yield spread between 2-year and 10-year Treasury bonds, for example, had been inverted for over a year. The yield curve turned positive in Q3 as the Fed finally started rate cuts, and it ended the year at its steepest point in 2-1/2 years (though still relatively flat historically), as the Fed signaled "higher-for longer" rates amid slowing disinflationary trends and resilient economic growth. Our expectations for interest rates have similarly evolved. We now see longer-term rates as more appropriately priced heading into Q1 2025. We believe the yield curve can continue to steepen in 2025, with stable or even rising long-term rates as a base case, given slowing progress on inflation, continued economic growth, and moderately paced rate cuts.

In traditional balanced portfolios, we have eliminated an overweight of fixed income, moving to a more neutral position relative to portfolio benchmarks. Across fixed income allocations, we have reduced average duration (interest rate sensitivity) by increasing short-term corporate credit exposure and trimming intermediate and longer-term Treasury bond exposure.

CONCLUSION

The mature economic cycle presents a mix of opportunities and challenges. While we see the potential for U.S. economic growth to extend through 2025, we remain mindful of risks tied to monetary, fiscal, and trade policy uncertainty, as well as market risks like valuations and sector concentration. We believe our current portfolio positioning represents an appropriate weighing of these factors, but, as always, we stand ready to adjust portfolios as our outlook evolves.

WestEnd Advisors Investment Team | January 6, 2025

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