WESTEND Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

Q1 2024

Late-Cycle for Longer

Slow-to-moderate growth seems likely in the U.S. through 2024, but late-cycle risks persist and international conditions remain tenuous. We see numerous return and risk management opportunities in this backdrop.

SUMMARY

- The global economy could see slow-to-moderate economic growth through 2024, but late-cycle risks remain.
- The Fed should have flexibility to manage real rates lower, though U.S. monetary policy appears likely to remain restrictive.
- We see opportunity in mid- and late-phase U.S. sectors, as well as Financials, given healthy balance sheets and likely Fed rate cuts.
- We still see a positive risk/return profile for fixed income.

Q1 2024 REVIEW

The global economy continued to exhibit late-cycle conditions in Q1 2024. Real economic growth in most major countries and regions, outside the U.S. and Japan, remains below-average versus the past decade, and U.S. GDP is widely estimated to have decelerated for a second consecutive quarter in Q1. The Federal Reserve (Fed) has signaled three rate cuts in 2024, and market hopes for as many as 5-6 cuts faded in Q1 as growth persisted and disinflationary gains slowed.

The global stock market extended a steady rally in Q1 2024, led by the U.S., where the S&P 500 Index returned 10.6% with below-average volatility. Returns were likely supported by generally solid earnings reports across multiple sectors, along with continued expectations for double-digit S&P 500 earnings growth in 2024 and 2025, and a modest uptick in consumer confidence.

The U.S. Communication Services and Information Technology sectors continued to post strong gains. While several of the widely touted "Magnificent 7" stocks were among the leaders in the S&P 500, strength was more broad-based, with a number of smaller tech-related stocks, as well as Energy, Industrials, and Financials performing well. Real Estate was the only U.S. sector with a negative return in Q1, as interest rates crept up, but the defensive, late-phase Health Care, Consumer Staples, and Utilities sectors also lagged the rising market.

International equity markets generally underperformed the U.S. in Q1 in U.S. dollar terms. Among developed countries, Japan was a positive outlier, outperforming the U.S. as its nominal economic growth remained sound and the Bank of Japan (BoJ) moved to a positive policy rate after nearly two decades of negative interest rates to battle deflation. Emerging markets generally underperformed, and Chinese markets posted negative returns amid ongoing issues with real estate and a failure to stimulate growth.

In domestic fixed income markets, the modest rise in longer-term rates weighed on returns as market expectations for Fed cuts re-aligned with Fed messaging. Corporate bonds mostly outperformed Treasury bonds as credit spreads approached record lows amid reduced equity market volatility and an apparent increase in investor risk appetite.

OUTLOOK

Positioned for Growth and Risks

We have modestly increased economic sensitivity across portfolios but maintain key mid-phase and defensive exposures.

Overview: At this point, we believe the global economy, and particularly the U.S., could maintain slow-to-moderate growth through 2024, but we continue to see late-cycle conditions overall, and risk of recession remains elevated compared to long-term history. A sustained reacceleration to early-cycle growth remains very unlikely, in our view, as the tight labor market and slowing disinflation reduce tailwinds for U.S. consumers. International markets remain less attractive overall, given monetary and economic headwinds.

Across our portfolios, we are taking a balanced approach to capitalize on opportunities to generate return and manage identifiable risks, both in the areas we are emphasizing and those we are underweighting or avoiding. In Q1, we adjusted our ETF portfolios to increase expected economic sensitivity while maintaining a reduced overweight of defensive exposures. For balanced portfolios, fixed income remains a source of diversification with an attractive risk/return profile, in our view, given the likelihood of Fed cuts and an elevated risk of recession.

U.S.: We continue to see two likely paths for the U.S. economy within our six-to-eighteen-month time horizon–either a "soft landing" with slow-to-moderate growth that extends the economic cycle or a slow-down with risk of recession. The recent resilience of some economic data, combined with additional flexibility for the Fed to cut rates amid slowing inflation, suggests to us that slow-to-moderate growth is the more likely outcome through 2024. Either way, the trajectory of U.S. growth appears to be slowing. While real GDP briefly surged in the

middle of 2023 to a 4.9% pace in Q3 as inflation cooled, it slowed to 3.4% in Q4 and is currently expected to have decelerated to around 2.0% in Q1 2024, in line with modest growth in the first half of 2023.

The **labor market** has supported growth in the U.S., and headline job gains remain positive. The participation rate, however, has recovered to near pre-COVID levels, making for further improvement challenging, in our view. Consumers have remained resilient, but the COVID-era savings cushion is essentially depleted and the savings rate is back near historic lows. Spending has also varied by category, with home improvement declining, for example, while travel spending remains robust. We see consumer spending growth becoming more reliant on income growth, which may be at risk if job and wage gains slow.

Elsewhere in the economy, a recovery in residential construction has been a relative bright spot, but its growth is still below the average of the 2010s expansion. Risks around commercial real estate and credit issues have largely faded from headlines but remain in place.

Monetary policy remains a key uncertainty. Market expectations have realigned with the Fed's signaling of three 25-basis point cuts this year. However, three cuts would keep monetary conditions tight, with real interest rates above our estimate of a neutral rate. Slowing disinflationary trends could also reduce the Fed's willingness to cut, but we believe the Fed has flexibility to manage real rates lower, given the moderating absolute level of inflation. Still, we believe a sharp policy easing is unlikely in the near-term absent material economic weakness.

A unique aspect of this cycle is the rapid advancement of **artificial intelligence (AI)**, which has the *potential* to transform nearly every sector of the economy. We have seen real impacts on revenue and earnings for some parts of the market, particularly mid-phase industries like Semiconductors, Software, and Interactive Media and Services. However, enthusiasm over AI seems to echo the hype over fiber optics in the late 1990s, when massive fiber infrastructure cap ex outpaced near-term demand. Internet traffic eventually grew into that infrastructure, but, in the interim, the boom turned bust for some high-valuation companies that had overinvested. We see a similar near-term risk for AI, even though the longer-term benefits of AI may be very real.

We also note that the **U.S. elections** are likely to contribute to market uncertainty and volatility this year. It is too soon for us to handicap the likely winners, and we generally do not make portfolio shifts predicated on assumed electoral outcomes. However, we do expect the elections will result in either divided government or the slimmest margin of control, either of which can reduce the risk of major legislative action.

Not Just the Magnificent 7
We see a range of mid-phase companies benefitting from continued late-cycle growth.

Given the late-cycle U.S. economic backdrop, we maintain **a mix of mid-phase and late-phase U.S. sector exposures** across portfolios. The mid-phase Communication Services and Information Technology sectors have led broad market earnings growth over the past year, driven in part by cost cutting and revenue growth. Margin expansion may be more difficult for these sectors going forward, but we anticipate revenue growth can support attractive earnings growth amid moderate economic growth. We note that sentiment has been ebullient around these sectors, and particularly the "Magnificent 7," which may elevate risk to valuations if earnings stumble, but we also see fundamental strength beyond the large, popular names.

The late-phase **Health Care** sector is our largest overweight across U.S. equity allocations. Its low economic sensitivity can provide defensive exposure in an economic slowdown, and we see the sector poised for an earnings rebound as post-COVID headwinds fade.

We continue to avoid most early-phase, cyclical U.S. sectors, given the low likelihood of a sustained resurgence in economic growth. However, we see opportunity in **Financials**, including Banks, where modest earnings expectations may undervalue the potential benefits of monetary policy easing (particularly for larger banks with strong balance sheets), and the Financial Services industry, where we see positive secular trends for credit card and payments firms. We also see a potential rebound for Capital Markets firms after weak activity in underwriting over the last two years pushed industry earnings down.

International: Outside the U.S., we see a mixed picture in Asia, where **Japan** continues to see healthy nominal GDP growth. The BoJ's recent move to (slightly) positive interest rates represents a step toward normalization after years of deflationary headwinds. We also see a broadening base of export growth for Japan beyond its strength in transportation. **China**, in contrast, continues to face deleveraging headwinds and has seen its growth rate drop below peers.

The **Eurozone and the U.K.** face tight monetary conditions and elevated, albeit slowing, inflation. Services sector activity has been resilient, but economic tailwinds (e.g., excess savings) continue to wane, and we still see risks to growth in the near-to-intermediate term. Emerging markets also face headwinds from slowing global growth.

Fixed income: Given Fed policy uncertainty and the inverted yield curve, long-term rates could drift higher in the near-term, but downside to rates seems more likely, given late-cycle conditions and likelihood of some Fed cuts. While we recently reduced fixed income exposure in traditional balanced portfolios, we retain a modest overweight, given our economic outlook and the attractive risk/return profile we see for bonds at this point in the cycle. Within fixed income, we are overweight intermediate and longer-term Treasury bonds, and have added to corporate exposure at short maturities. Our incrementally positive economic outlook supports this increased credit exposure, but near-record low credit spreads could put long-term corporate bonds at risk in the event of higher market volatility or economic weakness.

CONCLUSION

Moderate economic growth could persist in 2024, but late-cycle risks remain entrenched. We have adjusted portfolios where appropriate to modestly increase economic sensitivity and keep positioning in line with our evolving outlook. As always, we continue to evaluate the macroeconomic backdrop and are prepared to reposition as needed if we see either ongoing resilience or increased risks.

WestEnd Advisors Investment Team | April 1, 2024

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