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FINANCIAL ADVISORY GROUP LLC

Second Quarter 2024 Economic and Market Outlook

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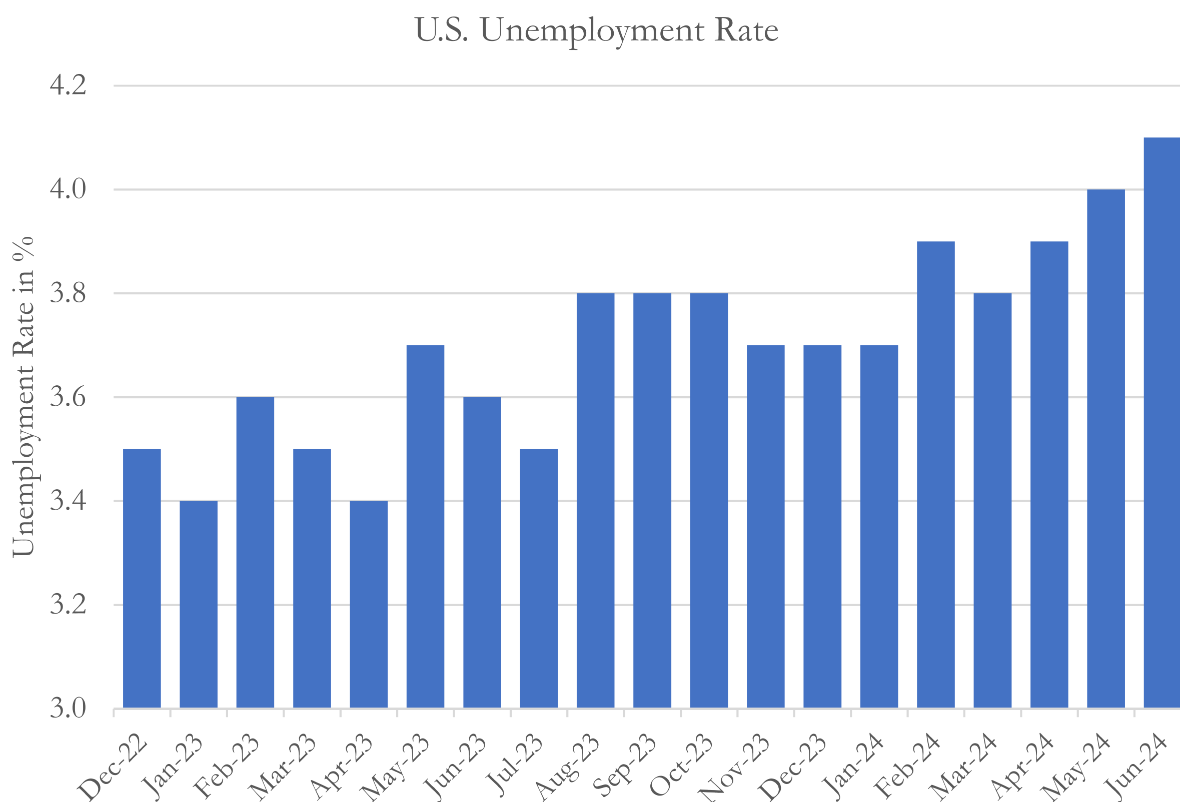
SECOND QUARTER 2024 ECONOMIC OUTLOOK

Economic conditions that surprised on the upside in the first quarter have cooled modestly. AI-mania and hopes of a successful soft-landing (lower inflation, full employment, moderate economic growth) have powered equity markets and bond yields higher so far this year. While the employment situation still looks relatively healthy, job openings and the quits rate have started to decline, wage growth has slowed, small businesses have indicated that they plan to hire less in the future and the unemployment rate has ticked up above 4.1%.

Figure 1: U.S. Unemployment Rate Rises as Economy Cools



Source: U.S. Bureau of Labor Statistics, Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UNRATE, July 19, 2024.

The Federal Reserve is focused not only on bringing inflation down but also maintaining full employment and they will set monetary policy accordingly in an effort to meet both objectives. The post-pandemic boom in jobs growth has started to slow and the unemployment rate has been trending higher since the end of 2022. This does not bode well for future consumption, particularly since the U.S. consumer is relying more on credit to support their spending recently. These are early signs of a slowing economy and, in order to prevent a potential recession, could lead to rate cuts by the Federal Reserve in the coming months.

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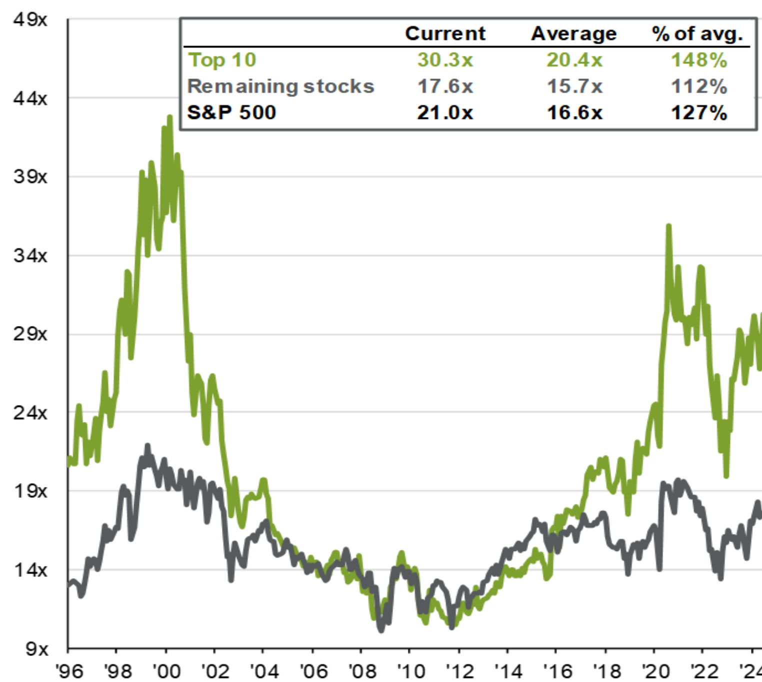
EQUITY MARKET STRENGTH CONCENTRATED IN FEW SECTORS AND COMPANIES

While the S&P 500 Index reached all-time highs during the second quarter, the lack of underlying breadth suggests the economy may not be as healthy as the headline results would suggest. This is best illustrated perhaps by the continued dominance of the large technology names in the market, with AI chip manufacturer, Nvidia, leading the way. Demand for AI-enabled technology remains strong and earnings growth for leaders in the space continue to surprise on the upside. However, other parts of the market have not fared as well and the performance difference between the top performers and the rest of the market has been significant.

Figure 2: The U.S. Market Concentration Risk Increases



Source: JP Morgan Asset Management Guide to the Market, 2Q 2024. The top 10 S&P 500 companies are based on the 10 largest index constituents at the beginning of each month. As of 6/30/2024, the top 10 companies in the index were MSFT (7.0%), AAPL (6.3%), NVDA (6.1%), AMZN (3.6%), META (2.3%), GOOGL (2.3%), GOOG (1.9%), BRK.B (1.7%), LLY (1.5%), JPM (1.3%) and AVGO (1.3%). The remaining stocks represent the rest of the 492 companies in the S&P 500. Guide to the Markets – U.S. Data are as of June 30, 2024.

The performance differential has led to a growing valuation discrepancy between the largest stocks and the rest of the market. **As illustrated in Figure 2**, the top 10 companies in the S&P 500 Index are now trading at over 30 times forward earnings while the rest of the market is trading at a more reasonable 17.6 times earnings. Further, the weightings of the largest 10 stocks in the S&P 500 has grown to 37.0% which is higher than it was even during the technology dominated markets of the late 1990's and during the narrow market that developed during the 2020 Covid-19 Pandemic. This

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level of concentration increases the chances of a significant market sell-off if any one of the top names disappoints or misses earnings.

U.S. ELECTION UNCERTAINTY

The events over the last several months in the U.S. Presidential race have shifted the dynamics significantly. Concerns over President Biden started to grow given his unsteady performance during the first debate with former President Trump. A failed assassination attempt on former President Trump at a campaign rally in Pennsylvania shocked the world. The Republican National Convention in Milwaukee, WI that followed provided more momentum behind the Trump/Vance ticket. This in turn ultimately led to the decision by President Biden to withdraw from the Presidential race and put his support behind Vice President Kamala Harris. The uncertainty will continue until the upcoming Democratic National Convention scheduled to take place in Chicago, Illinois in August through to Election Day in November 2024.

Opinion polls in early July indicated Trump was leading in the Presidential race, but this was before Biden made the decision to withdraw. Conventional wisdom is that a second Trump term would be good for stock markets and bad for bonds because the assumption is that corporate tax cuts would be a part of the Republican fiscal policy. However, the economic environment today is much different than it was in 2016. Because the U.S. budget deficit is now at 7.0% and bond yields are over 4.0%, future fiscal policy will likely be more restrained no matter who wins the White House.

OUR OUTLOOK

Wescott does not try to predict market outcomes, but rather builds portfolios that are balanced and well positioned in the event of market shifts and rotations. A company's future earnings growth is a critical factor in driving market returns, but investment returns also depend on valuation. Expectations remain high for leading technology companies and prices have moved up as a result. However, any shift in investor sentiment can change market leadership very quickly, whether driven by economic factors such as interest rates or inflation or by a change in the expected fiscal or monetary policy.

The bull market in the S&P 500 Index continued in the second quarter of 2024, but its leadership narrowed. The underlying strength in the U.S. economy has started to fade at the margin as evidenced by cooling inflationary pressures and a slowing labor market. The U.S. bond market stabilized again after a poor first quarter as investors anticipate the Federal Reserve's plan to start cutting rates later this year. However, we believe rising political uncertainty in the U.S. and ongoing geopolitical conflicts abroad along with historically high valuations in the technology sector support Wescott's balanced approach to portfolio management.

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