WESTEND Advisors

Economic and Market Commentary

Q1 2020

Contemplating the Shape of Things to Come

In terms of initial impact, the COVID-19 pandemic may be the greatest economic shock in living memory. For markets, given the damage to date, we believe we may be closer to the end than the beginning of the downturn, and we are seeking to manage risk around the potential inflection point.

SUMMARY

- The near-term economic impacts of the COVID-19 crisis will be severe, and global markets have reacted sharply, with stocks down as much as in a typical bear market in just weeks.
- Our macroeconomic outlook led us to relatively defensive portfolio positioning going into to the crisis; now we are focused on balancing risks of the crisis with future opportunity.
- We believe there has been progress in creating conditions for a stock market bottom, but the extent and duration of the economic impact, and in particular the labor market fallout, is still very uncertain.

Q1 2020 REVIEW

COVID-19 seemed to come out of nowhere, but the sharp market moves in response to the outbreak are not surprising, in and of themselves. Markets reacted sharply to uncertainty and, we believe increasingly, to the economic impact of policy responses such as lock-downs and business disruptions. The speed and severity of the economic impacts of the pandemic are extreme and reflect, in part, the unusual nature of this particular crisis. As equity markets tumbled, with the S&P 500 down as much as 34% from its recent peak on February 19, U.S. equity market volatility reached historic highs in mid-March, with the CBOE Volatility Index (VIX) even briefly exceeding its peak from the 2008 financial crisis.

While we could not have predicted a viral outbreak would be the cause of a bear-market-scale pullback in markets in 2020, we had been shifting portfolios to a more defensive posture over the past 12-18 months, guided by our overall macroeconomic outlook and approach to aligning risk exposures (e.g. sector allocation and avoidance) to the economic backdrop. In our view, the advanced economic cycle and extended equity valuations made global economies and markets particularly vulnerable to disruption. As a result, our portfolios were relatively well-positioned in the early stages of uncertainty and volatility in the unfolding crisis.

As COVID-19 began spreading outside of Asia, we focused on the potential magnitude and duration of the economic fallout. We have made various portfolio shifts to manage risk across our strategies as our outlook has evolved during this crisis. These shifts included dynamic adjustments to the economic sensitivity of U.S. equity sector exposure across portfolios, tilting further toward U.S. exposure in global portfolios, and adding to Treasury exposure and reducing fixed income duration in balanced portfolios. As a result, turnover in Q1 was substantially higher than is typical for our portfolios. While we view increased turnover as normal in periods of economic inflection, the current crisis has compressed portfolio transitions that might normally occur over months or quarters into a few weeks. This rapid increase in portfolio activity, while unusual, is a reflection of our dynamic, forward-looking investment approach, and is designed to keep portfolios aligned with the macroeconomic backdrop and our outlook.

OUTLOOK

There is no question that the economic falloff resulting from the COVID-19 pandemic will be severe, given the actions taken by governments and early data to date. By almost any measure, we expect the damage will get worse before it gets better. No one, in our view, can predict with any certainty the precise impact such an unprecedented shock will have on the economy. Markets, however, are forward-looking (though certainly capable of over- or under-reaction). Given the market declines so far, our analysis suggests we may be closer to the end than the beginning of the market downturn, at least in magnitude.

Focus on different data

Headline economic data, like GDP or industrial production, is stale before it is released. In this rapidly evolving environment, we are focused on more real-time data to gauge shifting trends in the outbreak and its impacts.

From a macroeconomic perspective, we are focused on how long-lasting the impact will be for the U.S. and global economies. While that, too, is not something we believe can be predicted with precision, history shows that markets tend to move in anticipation of actual economic movements. To understand when markets may stabilize, we are evaluating information in real time across four key areas. First, we are tracking COVID-19 health data to monitor the spread of the disease; second, as always, we are analyzing macroeconomic and market data, with a current emphasis on high-frequency or near real-time economic and company data; third, we are keeping a close eye on the health of credit markets; and, fourth, we are evaluating fiscal and monetary responses in the U.S. and other major economies.

We see a wide range of potential factors that could serve as the catalyst for a market bottom, individually or in combination. From a health care perspective, clinical advances in treatment of the virus could change the trajectory of the pandemic, though we have no specific expectation of this in the near term. A more likely catalyst could be a slowdown in case growth suggesting the outbreak will peak. We might see the first signs of this abroad, where outbreaks and policy responses have had more time to run their course. Globally, we have seen a slight reduction in the growth rate of confirmed cases at the end of March, even as testing for the virus has risen, but this data remains in flux and U.S. case growth remains high for now. More anecdotally, if the U.S. health care system can demonstrate resilience, effective patient management, and a lower-than-expected mortality rate (even without clinical advances in direct treatment), it could ease uncertainty and allow loosening of economically-stifling lockdown restrictions.

Possible economic catalysts for a market bottom include support for the credit markets that reduces strain on the financial system and limits business failures. The Federal Reserve's virtually unlimited support has already helped stabilize credit markets in the near-term, though volatility remains heightened across financial markets compared to historical levels. Fiscal stimulus should hopefully limit the risk that the initial labor market shock spreads from areas like hospitality and airlines to other industries and creates a self-dampening demand spiral. The $2 trillion U.S. stimulus package passed at the end of March already seems to have calmed markets, and we anticipate more stimulus ahead.

Regardless of the ultimate catalysts for a market rebound, we believe we have seen progress in creating conditions for a bottom. The magnitude of the S&P 500's decline thus far is in line with average historic bear market returns. Although significant risks remain, particularly in the U.S. labor market, this suggests to us that stocks are closer to the end than the beginning of their decline.

As this downturn has progressed, we have seen the risk/reward profile of market segments evolve. Sharp declines in some early-phase, cyclical sectors are providing an appropriate opportunity, in our view, to begin positioning portfolios for an eventual rebound. Accordingly, we have increased exposures to more economically-sensitive and higher-beta areas of the markets across portfolios, including establishing allocations to the U.S. Financials, Industrials, and Energy equity sectors. In global portfolios, we have also increased U.S. exposure with a new small/mid-cap equity allocation and, while reducing international allocations and tilting international exposure more toward emerging markets. In fixed-income allocations, we have retained an overweight to corporate bonds and reduced duration to manage risk.

We also recognize, however, that significant economic and market risks remain. Thus, in the near-term, we are maintaining diversified exposure across a higher number of U.S. large-cap equity sectors than is typical. Given the severity of the current shock and uncertainty regarding the timing and magnitude of a potential rebound, we believe this balanced approach to risk management is warranted as we transition through what is likely to prove a major economic inflection point. With a long history of managing portfolios through periods of economic turmoil, our experience and resources are focused on navigating the market impacts of this pandemic on behalf of our clients.

WestEnd Advisors Investment Team | April 1, 2020

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