WESTEND Advisors

Seeing Economic Recovery, Managing Continued Risks

There has been a strong pickup in economic activity in recent weeks, which the markets seem to have anticipated. We believe our portfolio positioning balances the potential opportunity from a continued market rebound against ongoing risks.

SUMMARY

- We believe a U.S. economic recovery is underway, and that it is tracking ahead of our expectations from early Q2.
- U.S. retail spending data is improving faster than retail traffic data, and U.S. consumers have amassed significant savings that we believe could fuel continued consumption growth.
- We have continued to shift away from the defensive portfolio positioning we had in place at the start of the COVID-19 crisis, while seeking to balance opportunity against ongoing medical, political, and economic risks.

Q2 2020 REVIEW

As Q2 2020 began, the U.S. had surpassed China, Italy, and other COVID-19 hotspots to have the highest number of confirmed cases in the world, the Federal government had just passed a $2 trillion stimulus package, states across the country were implementing lockdowns, and global stock markets were deep in negative territory for the year after posting the steepest 30%+ decline on record in Q1. In our view, however, the ingredients were beginning to fall in place for an eventual economic recovery.

We had entered 2020 with fairly defensive portfolio positioning, as we believed that the maturing economic cycle made economies and markets vulnerable to disruption (though we did not anticipate a pandemic). As COVID-19 spread beyond Asia, we focused our analysis on high-frequency and near-real-time data across four key categories: heath data, monetary and fiscal actions, credit market function, and macroeconomic data. This led us first to increase defensive portfolio exposures, and then, ahead of Q2, to begin shifting away from that defensive stance in anticipation of an economic and market rebound. We trimmed U.S. Health Care and Consumer Staples equity exposures, and added new U.S. Industrials, Financials, and Energy allocations. In global portfolios, we also reduced international exposure and added a small-cap U.S. equity allocation. Thus, we entered Q2 with new exposures to highly economically-sensitive U.S. sectors, yet still maintained defensive sector exposures, balancing ongoing uncertainty with the potential for faster-than-expected recovery.

As Q2 progressed, the rebound of global equities off of their late-March lows continued through most of the quarter. The MSCI ACWI returned 19.2% in U.S. dollar terms in Q2, led by the U.S. and a mix of international markets, like Germany, Brazil, and Australia, while the U.K., France, China, and many other major international markets lagged. Within the U.S., Q2 performance was led by Consumer Discretionary, Info Tech, and Energy (the worst performer in Q1). Small-cap U.S. stocks outperformed in Q2 after lagging in Q1. Defensive sectors like Consumer Staples, Health Care, and Utilities went from being among the best-performing U.S. sectors in the Q1 downturn to underperforming in the Q2 rebound.

Economically, we saw a continuation in Q2 of some of the recovery trends we had initially discerned in late Q1. This gave us incremental conviction that a recovery was gaining traction and provided a better understanding of the attributes of that recovery. Thus, in mid-June, we further tilted U.S. equity allocations away from defensive areas that had outperformed in Q1, and toward more economically-sensitive U.S. sectors that were still lagging year-to-date. These adjustments included becoming more focused in our sector positioning by eliminating our remaining large-cap U.S. Utilities exposure and adding to the U.S. Financials and Industrials allocations established in Q1.

Recovering from pandemic
The strong initial rebound in economic activity sets up a better trajectory, in our view, for the recovery in the quarters ahead.

OUTLOOK

We believe that an economic recovery is underway. There has been a strong initial rebound in economic activity in the U.S. from the COVID-19 pandemic downturn, which we believe sets up a better trajectory for economic growth in the quarters ahead. A stabilization in COVID-19 case data (though new cases are rising again in some areas as lockdowns are eased), the Federal Reserve's virtually unlimited support for credit markets, and the U.S. government's large fiscal stimulus response to the pandemic all helped set the stage for recovery. Now, some of the most timely economic data are showing improvement in key areas, including retail spending and leading indicators of employment, even as many quarterly and monthly economic releases that are reported with significant lag continue to show sharp deterioration.

The U.S. economic rebound appears to be tracking slightly ahead of what we had anticipated as recently as mid-Q2. For example, in recent weeks, advance retail sales data and weekly credit/debit card spending data suggest retail purchases are nearly back to their pre-crisis level, though the mix of spending has shifted materially, both in the categories of goods purchased and with an increase in online purchasing. While overall Personal Consumption Expenditure (PCE) remains depressed due to reduced travel and ongoing restrictions on hospitality businesses, retail spending in areas like home goods and grocery appears strong, in our view.

Additionally, despite current high unemployment, we believe U.S. consumers, in aggregate, are in a stronger position than is widely recognized. Given a slight gain in payrolls in the May employment report (versus a consensus expectation for net job losses), the mix of job losses skewing toward lower earners, supplemental unemployment payments and direct transfers from the Federal government, and the reduction in consumer spending in March and April (which created additional savings), we expect consumers will have about half a trillion dollars of additional spending power going into the fall of 2020. This is the equivalent of more than 3.4% of nominal PCE, which we believe, on top of recent spending trends, could translate into a significant rebound in consumer spending in the second half of 2020 and into 2021.

The prospects for international economies are less clear. Europe, for instance, has seen a much greater reduction in confirmed new cases of COVID-19 and began reopening a little sooner than the U.S., but European economies were already facing greater challenges before the crisis, in our view, than the U.S., and the structure of the EU has limited the speed and scope of fiscal stimulus across the region. European economies, overall, are also very reliant on tourism, which remains heavily impacted by the pandemic. Asia, meanwhile, was the first region hit by the pandemic and among the first to begin reopening at scale, but many Asian economies rely on global trade, which remains constrained. We continue to underweight international equities in global portfolios, given the relative economic strength of the U.S., opportunities we see in certain U.S. sectors, and risks abroad.

We are monitoring a wide range of risks globally. As COVID-19 lockdown restrictions are eased, there is the potential for a further pickup in infections that could lead to consumers pulling back and some limited renewal of lockdown measures. Separately, economic traction, along with record monetary easing and fiscal stimulus, increases intermediate-term risk that inflation expectations move higher, in our view, which could put upward pressure on long-term interest rates and, in turn, downward pressure on bond prices and equity valuations. Beyond COVID-19, the 2020 U.S. election and current social unrest present additional uncertainty for investors.

Overall, portfolio shifts we have made to increase economic sensitivity have been measured and balanced against these and other risks. We have kept or added exposures that we believe have favorable tailwinds in the current environment. For example, we retain significant exposure to the U.S. Consumer Discretionary sector, which is weighted toward companies we believe benefit from an accelerated shift to eCommerce. We have also added to U.S. Financials exposure, as we expect bank profitability to improve as fewer loan loss provisions are required amid the economic rebound and capital markets firms should benefit from increased trading and capital markets activity, as well as record debt issuance.

In summary, we have increased optimism for the strength of economic recovery in the U.S., but we also see risks to recovery and will adjust portfolios accordingly as our outlook evolves.

WestEnd Advisors Investment Team | July 1, 2020