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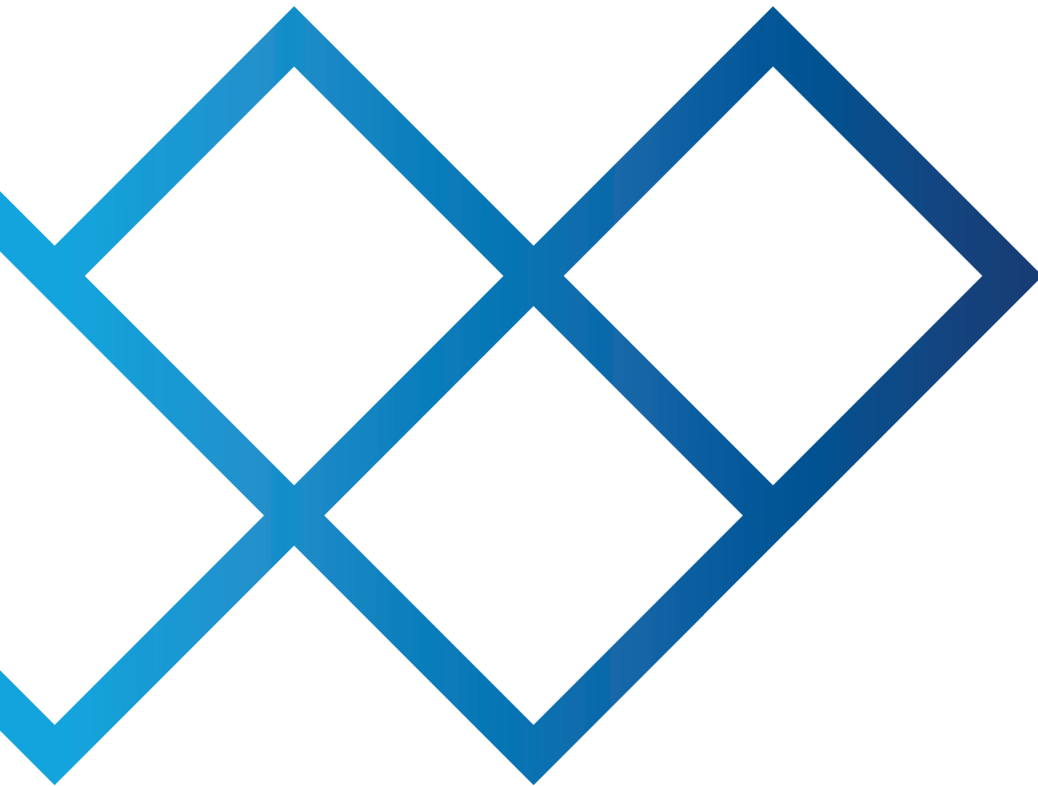

Macroeconomic Highlights

Q3 2020

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WestEnd Outlook Highlights

- 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 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 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. Since late Q1, 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.
  - Increased U.S. equity exposure in global portfolios with a new small/mid-cap equity allocation and, while reducing international exposure, tilted international allocations toward emerging markets.
  - Retained an overweight to corporate bonds in fixed-income allocations and reduced duration to manage risk.

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U.S. Equity Sector Allocations

WESTEND ETF STRATEGIES

Large-Cap U.S. Equity Sector Positioning and Q2 2020 Adjustments as of June 30, 2020*

Sector Exposures Increased

- Financials
- Industrials

Sector Exposures Decreased/Maintained

- Consumer Discretionary
- Communication Services
- Consumer Staples
- Energy
- Health Care
- Information Technology

Sectors Avoided

- Materials
- Real Estate
- Utilities

* For illustrative purposes only. Sector changes based on U.S. Sector Strategy model portfolio comparing allocations on March 31, 2020 and June 30, 2020. Source: WestEnd Advisors.

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U.S. Economic & Market Backdrop

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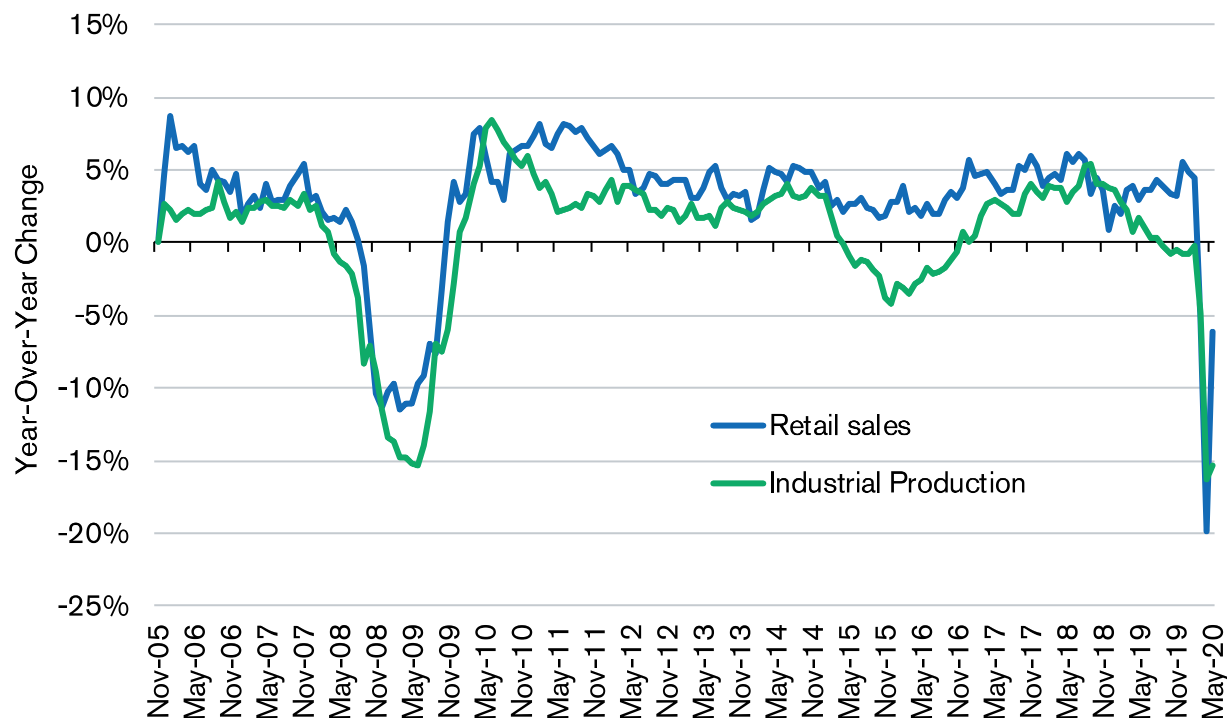
Early Signs of Recovery from Sharpest Recession in a Century

U.S. CONSUMER AND MANUFACTURING ACTIVITY



Source: WestEnd Advisors

Portfolio Impact: Minimized financial market tail risks from government action and traction with the U.S. economic recovery warrant significant allocations to economically sensitive sectors like **Information Technology, Financials** and **Communication Services**. Continued, but smaller allocations to less economically sensitive sectors like **Health Care** and **Consumer Staples** are appropriate as health and economic risks remain.

An already mature and vulnerable U.S. economic cycle was hit in Q1 with the largest economic shock in a century. The purposeful cut back in economic activity to fight the spread of the COVID-19 virus resulted in severe contractions in consumer spending and manufacturing activity that surpassed the declines in the 2008 financial crisis.

The U.S. government's response, however, was equally unprecedented, including the Fed's support of credit markets and the fiscal stimulus to support consumers and businesses. **These government actions along with progress in managing the health crisis led us to believe late in Q1 that the ingredients for an economic recovery were in place, which warranted shifting portfolios to a more economically sensitive posture.** Even as risks persist, we have seen Q2 economic data like the May Retail Sales report indicate the economic rebound is beginning play out.

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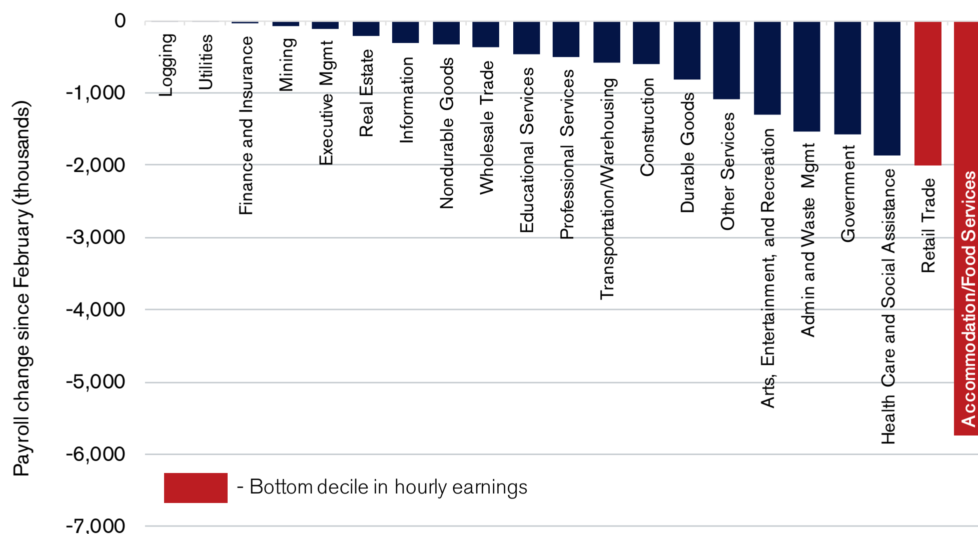
Severe Economic Fallout Demands Digging Below the Headlines

COVID-19 JOB LOSSES



Source: WestEnd Advisors, BLS

CATEGORIES OF CONSUMER SPENDING IN COVID-19 ENVIRONMENT

Impact from COVID-19:	Traditional Economic Cyclicality: High	Traditional Economic Cyclicality: Low
High	22% of Spending • Auto Sales • Non-road Travel • Restaurant/Hotel	24% of Spending • Physician & Hospital • Road Transportation • Child Care
Low	13% of Spending • Financial Services • Appliances • Electronics/Computers	41% of Spending • Housing & Utilities • Packaged Food & Beverage • Pharmaceuticals

Source: U.S. Bureau of Economic Analysis, WestEnd Advisors

Portfolio Impact: Allocations to **economically sensitive exposures like small-cap are appropriate** even as many economic headlines remain ugly. Personal income declines, for example, are not as severe as job losses since the labor market fallout from the virus-induced recession has primarily been focused in low-wage industries, such as restaurants, leisure & hospitality, and retail. See top chart.

The Covid-19 recession had widely varying impacts on different segments of the U.S. economy. The industries with the largest number of job losses through May *(more than half of payrolls losses)* are in the bottom decile of average hourly earnings. With regard to consumer spending, the severity of the impact across different industries was largely dependent on the necessity of the goods and services provided. Roughly 45% of total Personal Consumption Expenditure was heavily impacted by lockdowns and stay-in-place orders, including spending on travel, dining, and motor vehicles.

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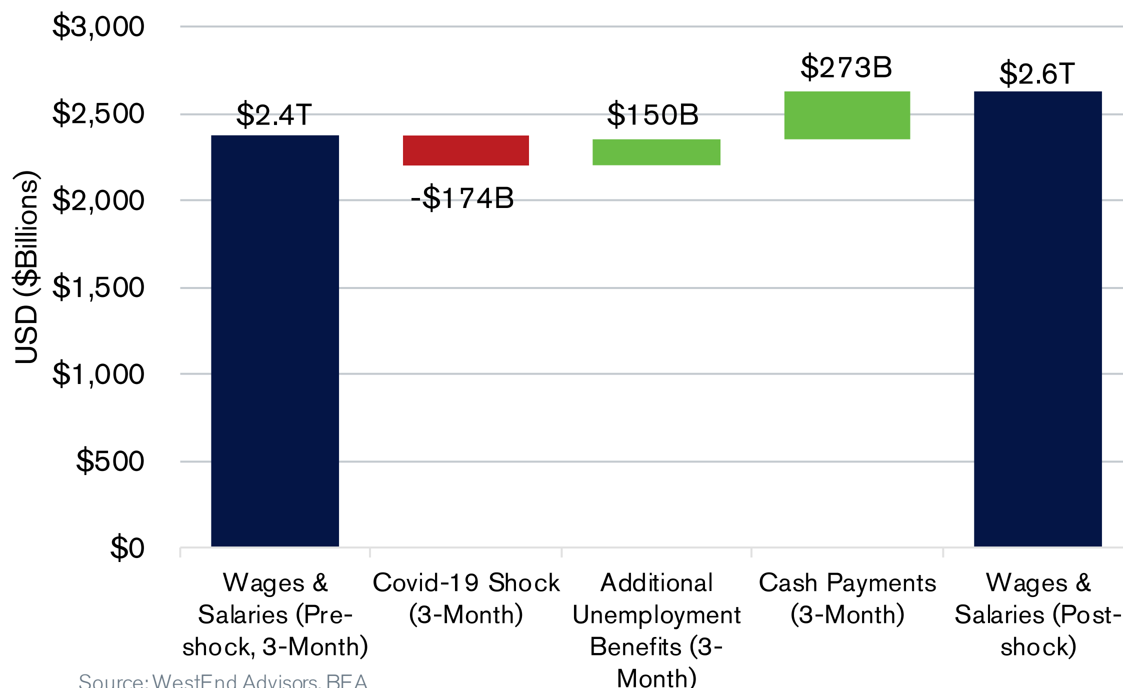
Fiscal Support has More Than Offset Income Losses

COVID-19 WAGES & SALARIES IMPACT



Source: WestEnd Advisors, BEA

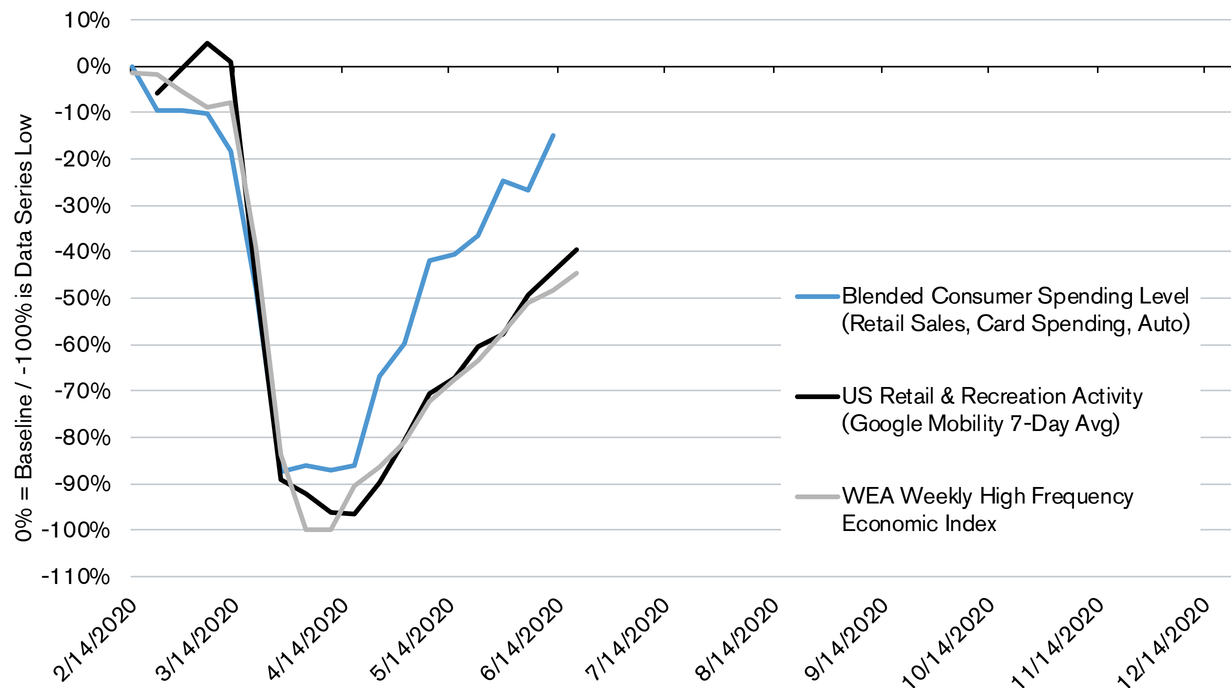
Portfolio Impact: Early Q2 data indicates that spending has rebounded faster-than-expected, driven by supplementary income provided by fiscal stimulus and relatively healthy household balance sheets. We believe this should bode well for the overall economy and the **Consumer Discretionary Sector** companies, which should benefit as consumer spending recovers and employees are brought back into the labor market.

Fiscal stimulus, in our view, should limit the risk that the labor market shock spreads from industries like leisure, hospitality and retail trade to other industries and leads to a further decline in personal income and spending.

Through May, wages and salaries fell by ~$174 billion relative to pre-COVID levels. The chart above shows that the income relief measures in the CARES Act, which included one-time cash payments totaling ~$273B through May as well as an expansion of federal unemployment benefits, have more than offset the recent income losses. Both measures took effect in April and have helped smooth the cash flow shock to households and businesses.

High-Frequency Data Indicates a Sharp Initial Rebound

RETAIL SPENDING RECOVERY VS. BROAD ACTIVITY MEASURES (NORMALIZED)



Source: WestEnd Advisors

Portfolio Impact: We believe that an economic recovery is underway, which appears to be tracking ahead of our expectations as of early Q2. **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 risks**.

The economic moves this year have been swift, both to the downside and to the upside. **To monitor these trends, we have increased our attention on a variety of high-frequency (daily and weekly) data series that cut across all major aspects of the economy**, including consumer spending, manufacturing activity and the labor market.

These high frequency indicators pointed to a stabilization in economic activity in early April and a broad **rebound in activity in the weeks that followed across both early opening and slow-to-open states**. In addition, the chart above indicates that the strong recovery in consumer spending has outpaced the level of activity at retail locations (measured by Google's mobility data), as consumers shifted their habits to include increased online spending and more curbside pickup.

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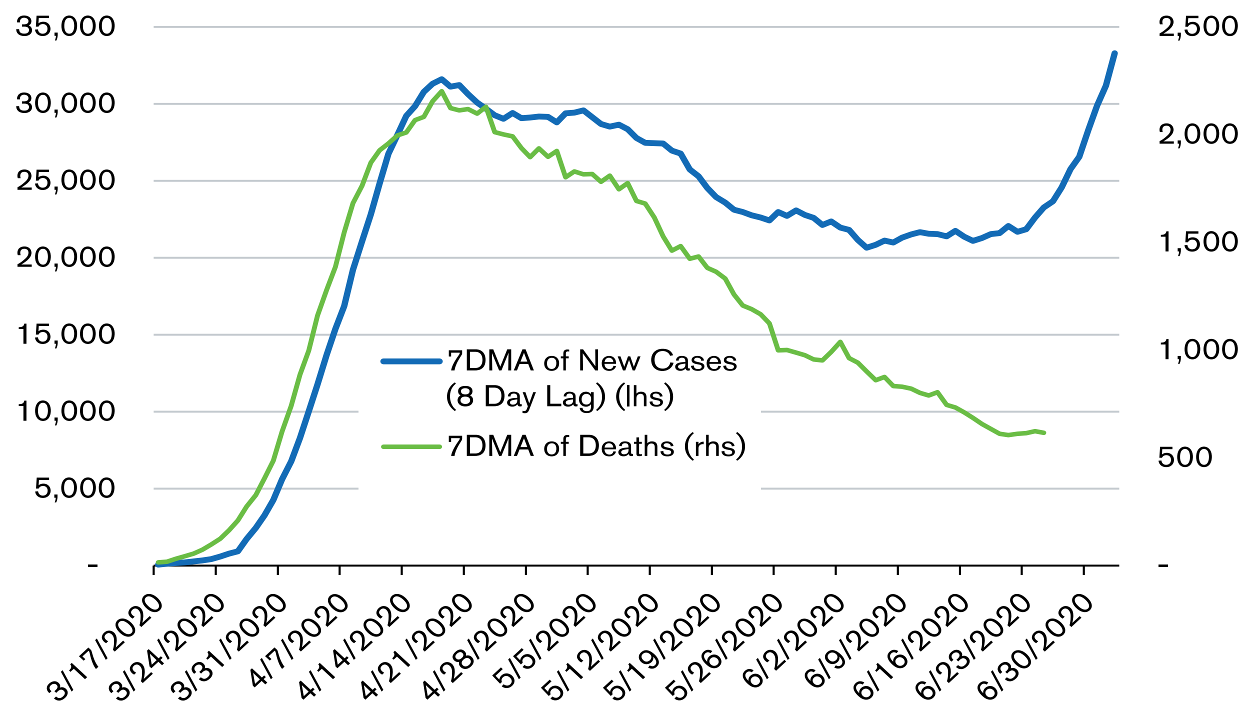
U.S. COVID Cases Pick Up, But Treatment of Patients Improves

UNITED STATES DEATHS VS. NEW CASES



Source: WestEnd Advisors

Portfolio Impact: Market sentiment has improved since late April, driven in part by improving COVID case and death trends in the U.S.. **The recent uptick in cases, however, could lead consumers to curtail activity and slow the pace of the economic rebound and rehiring.**

Daily new COVID cases in the U.S. are back to new all-time highs as slowing growth in northeastern states including NY, NJ, and MA has been more than offset by **rapid increases in cases in early re-opening states including GA, TX, AZ, and NC, among others.** This development highlights the risks related to reopening. We would note, however, that new cases have become less effective in predicting fatal outcomes, as testing has ramped up significantly (note that the U.S. is testing 3x as many people per day now vs. late April) and the **medical community has become more informed on effective approaches to treat the virus**.

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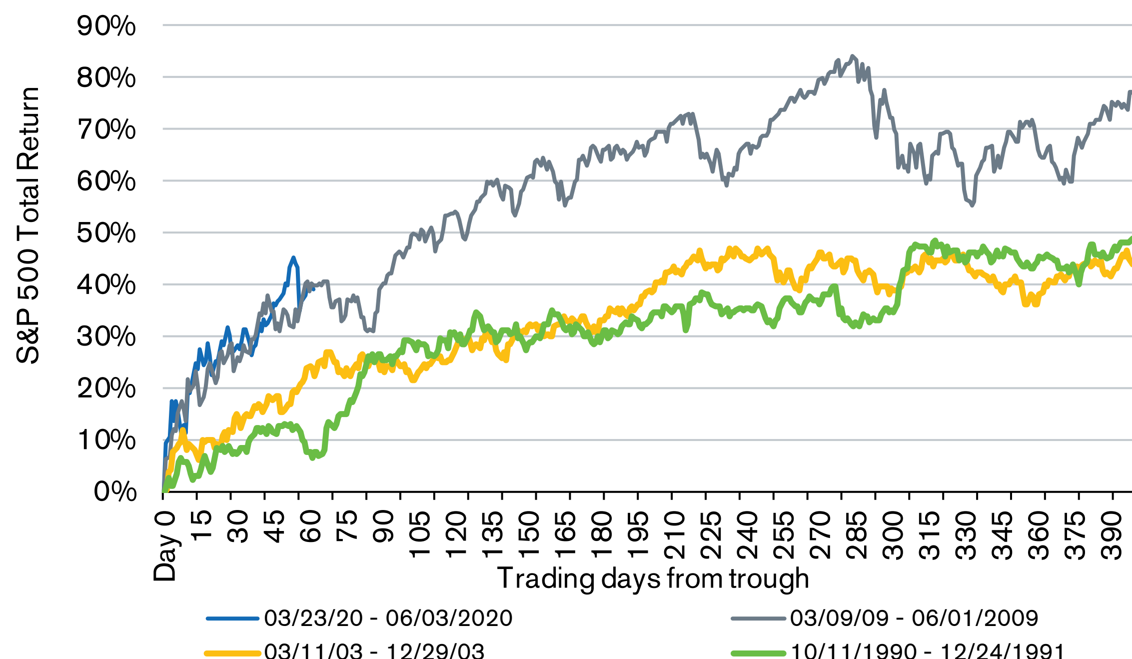
Fast Start to the Recovery, But Supported by Sharp Turn in Fundamentals

S&P 500 RECENT POST-RECESSION MARKET RECOVERIES



Source: WestEnd Advisors

Portfolio Impact: The market has come a long way from the March 23rd bottom, which has made market risks and opportunities more balanced at this point. Over the intermediate term, however, **significant fiscal and monetary support** for consumers and businesses, as well as **attractive interest-rate adjusted equity valuations**, should set the stage for improved equity returns during the recovery.

While the speed and severity of the economic impact of the pandemic has been extreme, the fiscal and monetary response was equally as rapid and strong. The market reacted in kind, with the S&P 500 rising almost 40% from the March 23rd trough - after declining over 30% at the fastest pace on record in Q1.

The Q2 market rebound marked the fastest 40% rise since the end of the Great Depression. Despite this significant rebound, **equity valuations remain attractive compared to history when adjusted for the record low level of long-term interest rates**. The current S&P 500 Trailing Earnings Yield (E/P) less the 10-Year Treasury yield indicates interest-rate-adjusted equity valuations have only been lower less than 10% of the time over the last fifty years.

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Fundamentals Drive Sector Performance Through the Market Cycle

Portfolio Impact:

Sector allocation provides a powerful tool in portfolio construction. In the last few months, we have **established allocations to sectors like Financials, Industrials, and Energy**, which we consider to be among the most economically sensitive sectors. Over the same period, we **eliminated or reduced exposure to the Utilities, Consumer Staples, and Health Care sectors.**

S&P 500 Sector Leaders and Laggards

Market Decline (Feb 19 to March 23)

Top 3 Sectors	
Consumer Staples	-24.04%
Health Care	-27.91%
Communications Services	-29.57%

Bottom 3 Sectors	
Industrials	-41.69%
Financials	-42.92%
Energy	-55.92%

Recovery (March 23 to June 30)

Top 3 Sectors	
Energy	61.08%
Information Technology	48.97%
Materials	47.84%

Bottom 3 Sectors	
Financials	32.32%
Utilities	27.14%
Consumer Staples	21.08%

Source: Bloomberg, WestEnd Advisors

The average difference in returns among segments of the market over the last three decades indicate that dispersion of returns among sectors provides greater alpha generation opportunity than style allocation factors (growth vs. value, capitalization ranges).

Economically sensitive sectors like Energy and Financials typically see sharper changes in earnings during economic contractions and recoveries than defensive sectors like Utilities and Consumer Staples. These fundamental relationships can translate into significant sector dispersion around economic inflections points. The table above highlights how sector leadership flipped from the Q1 market decline to the subsequent recovery.

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U.S. Sector Outlook

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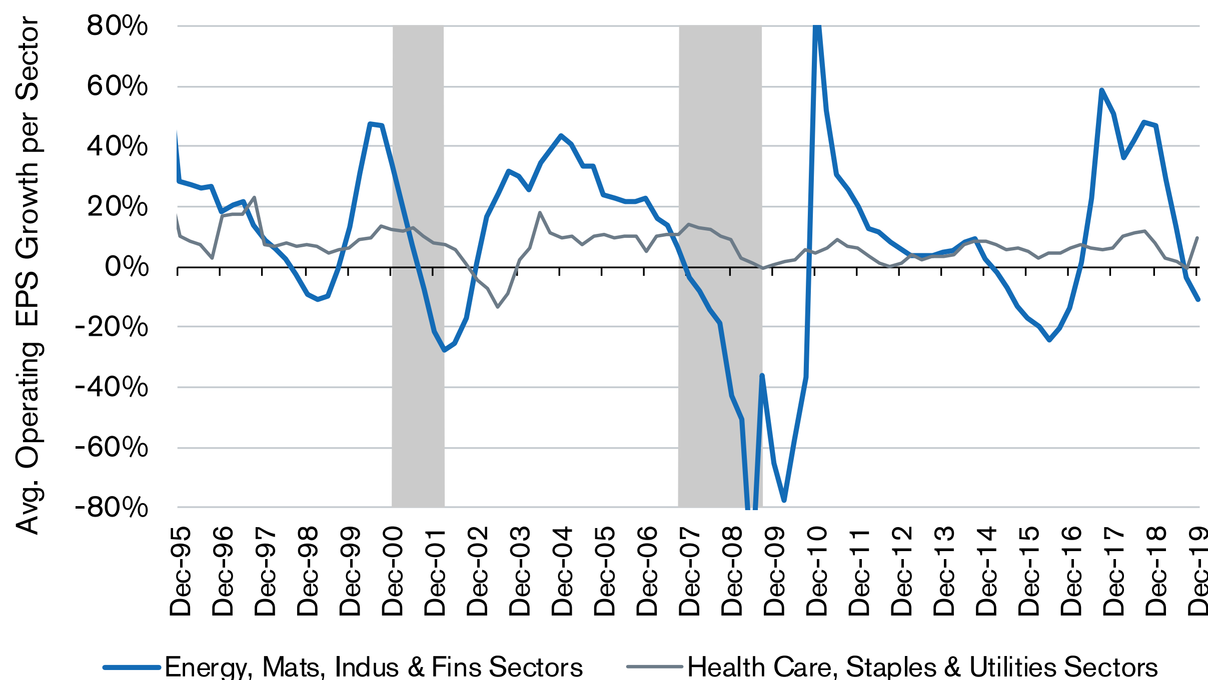
Sector Exposures to Various Earnings Growth Profiles



Source: Bloomberg, WestEnd Advisors

Portfolio Impact: Uncertainty remains about the shape of the recovery. Thus, we are maintaining diversified exposure across defensive and economically sensitive sectors.

Health Care & Cons. Staples: Steady earnings, more insulated from cuts to discretionary spending.

Industrials & Financials Sectors: More economically-sensitive sectors that should benefit from a recovery.

We have seen the risk/reward profile of market segments evolve. **Sharp declines in some early-phase, cyclical sectors in Q1, like Industrials and Financials, provided an appropriate opportunity, in our view, to begin positioning portfolios for an eventual economic recovery**. At the same time, there is still significant uncertainty about the path of growth after the initial reopening rebound. This **uncertainty warrants ongoing exposure to more defensive sectors** like Health Care and Consumer Staples that can deliver less variable earnings growth.

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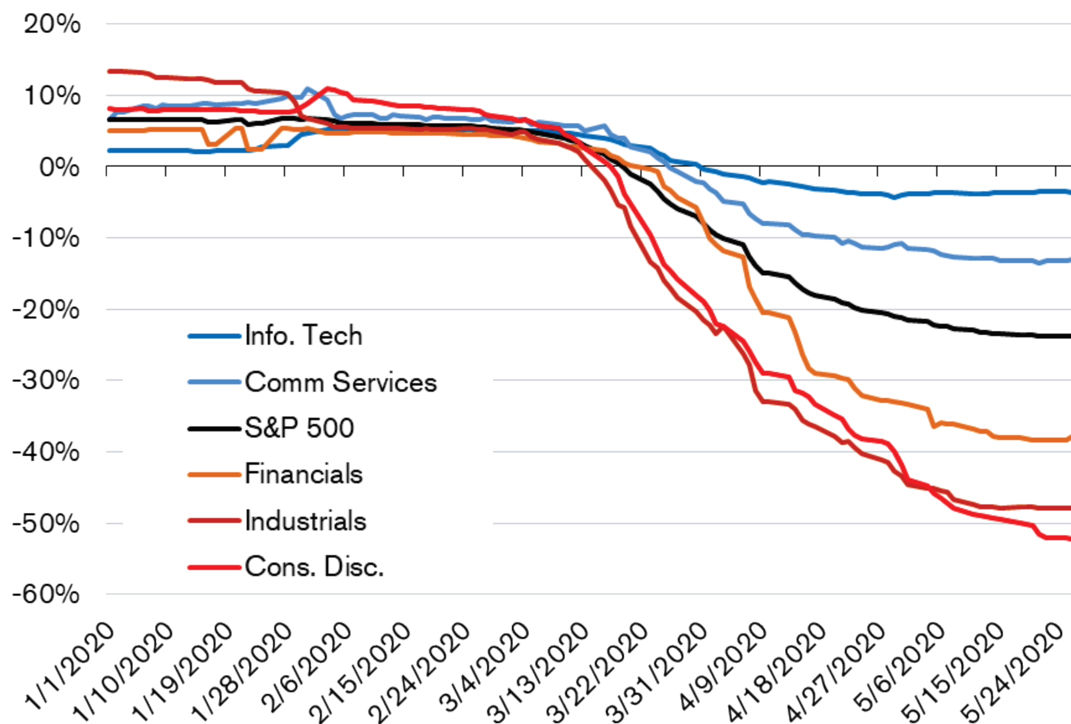
Tech-Oriented Sectors Insulated from COVID-19 Headwinds

2020 EPS CONSENSUS ESTIMATE EVOLUTION



Source: WestEnd Advisors, Bloomberg

Portfolio Impact: In the near-term, all forms of business investment are likely to face headwinds stemming from uncertainty around COVID-19. Nevertheless, we believe material allocations to the **Information Technology** and **Communication Services sectors** are warranted regardless of the exact shape of the economic recovery given the secular tailwinds benefiting these sectors.

Businesses and consumers have increasingly embraced digital platforms like cloud computing, eCommerce and social media in recent years. The nature of the coronavirus pandemic means that today these types of spending are less likely to be negatively impacted compared to a traditional recession, and in certain cases, like digital video conferencing software and video gaming platforms, companies are seeing increased demand. The chart above illustrates that **earnings estimates for Technology and Communication Services companies have been insulated from the economic damage created by the COVID-19 pandemic, compared to other economically sensitive sectors and the S&P 500 overall**.

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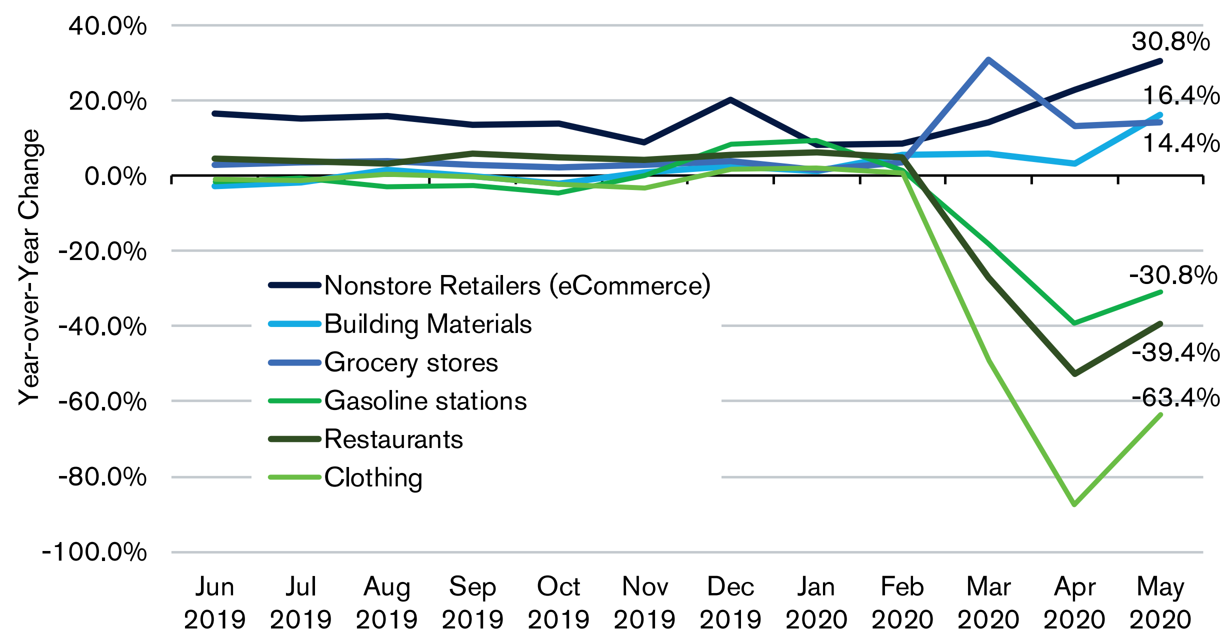
Consumer Spending Winners and Losers have Emerged

SHIFTS IN RETAIL SALES CATEGORY GROWTH POST-COVID-19



Source: WestEnd Advisors

Portfolio Impact: Fundamentals in the **Consumer Discretionary** Sector are likely to remain mixed as the recovery progresses. However, the two largest sub-industries, Internet & Direct Marketing Retail and Home Improvement Retail, and **the leading companies in those sub-industries, are benefitting from the shift in spending towards eCommerce and building materials**.

Consumer spending was hard-hit by the COVID-19 outbreak, primarily due to widespread business shutdowns. As of May, retail sales were still ~8% below pre-recession levels, despite a quicker-than-expected rebound driven by pent-up demand.

However, as the chart above demonstrates, **certain consumer sub-industries have benefitted, while others have seen serious sales declines**. Areas that provide essential or delivery services have recorded high teens or better year-over-year growth. Conversely, restaurants and brick-and-mortar clothing stores have seen sales fall sharply. We expect some of the altered consumer habits will endure and thus create investment opportunities in our 12 to 18 month investment window.

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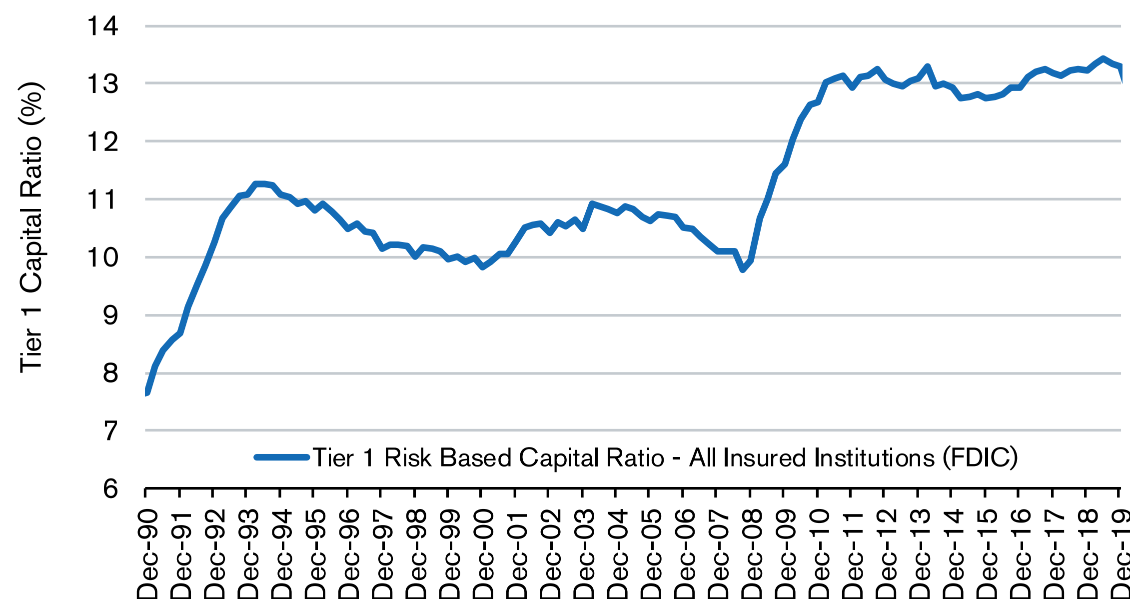
Financials Sector: Poised to Weather the Downturn



Source: Federal Deposit Insurance Corporation

Portfolio Impact: Financials are well positioned in our view to benefit from the next phase of the economic recovery. **The strong initial rebound should limit banks' need for additional loan loss provisions**, especially given the support provided to businesses and individuals by the federal government.

The Financials Sector was hard-hit in Q1 by a mix of factors related to the COVID-19 outbreak, including the slashing of short-term interest rates by the Federal Reserve and a flattening of the yield curve (which can reduce net interest margin for lenders), a tightening of credit market conditions, and reduced demand for capital markets advisory business.

However, as the chart above shows, **U.S. financial institutions are well capitalized following regulatory changes implemented since the 2008 financial crisis**. In our opinion, the improved capital position together with a sharp recovery in economic activity and substantial government support should lead to **smaller loan loss provisions for banks in the second half of 2020** and, in turn, **a better-than-consensus recovery in Financials sector earnings**.

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International Economic & Market Backdrop

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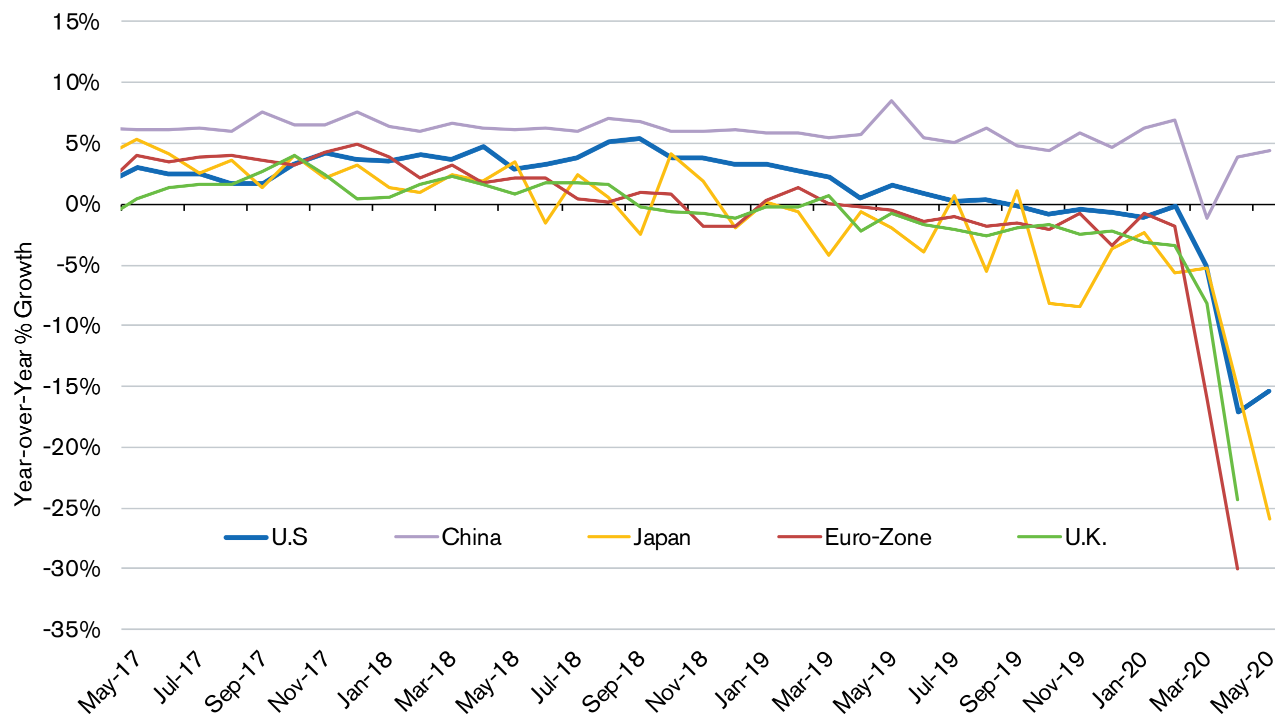
European Manufacturing Continues to Suffer Most



Source: U.S. Federal Reserve, U.K. ONS, Eurostat, Japan METI, China, NBS, WestEnd Advisors

Portfolio Impact: Given **Europe's and Japan's weaker economic fundamentals compared to the U.S.** ahead of the COVID-19 crisis, these regions could see more prolonged damage due to the current economic downturn. Our **global strategies maintain underweights to Europe and Japan**, with Europe being our largest regional underweight.

European manufacturing continues to suffer as the region (Euro-Zone and U.K.) experienced sharper year-over-year declines than the U.S. , Japan and China during April. **The sharp falloff in European industrial activity in recent months follows a 15-month streak of year-over-year declines for Euro-Zone industrial production and year-over-year declines in 16 of 17 months in the U.K.**

Moving forward, Europe will cope with more damaged industry, which is also more impactful to overall European GDP. For example, in the Euro-Zone, industry makes up 25% of GDP vs. 19% in the U.S.

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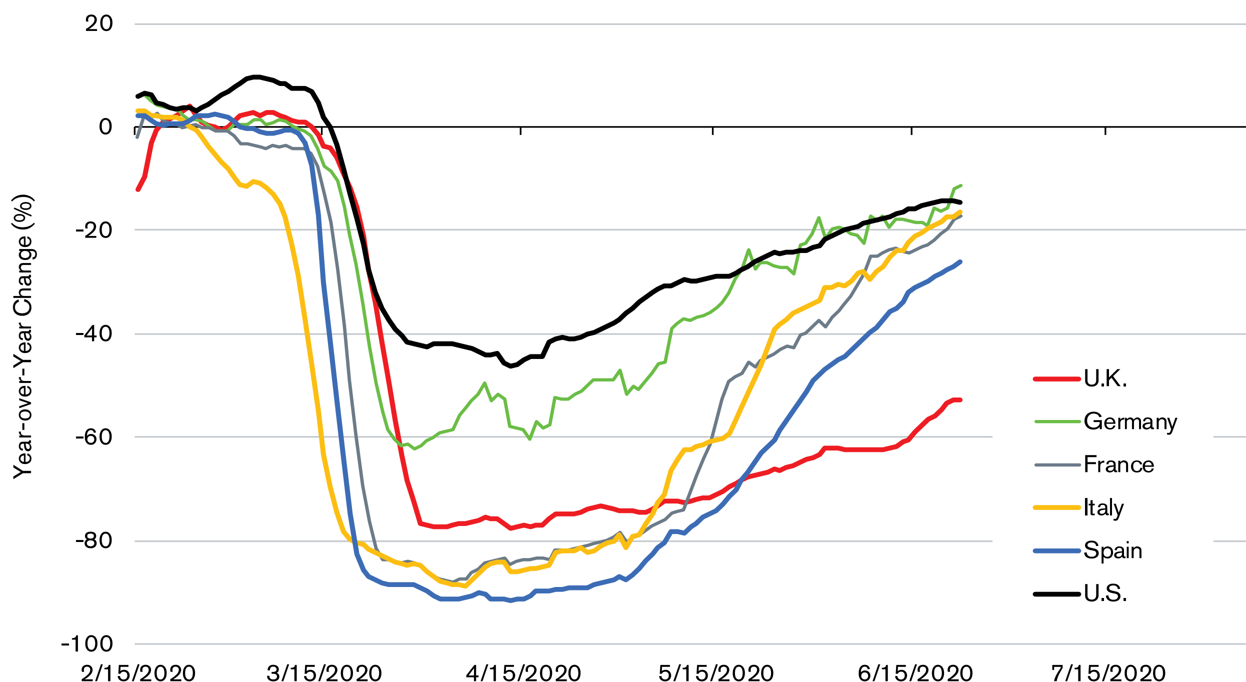
European Mobility Up, But From a Lower Base

RETAIL & RECREATION MOBILITY (7-DAY AVG)



Source: WestEnd Advisors

Portfolio Impact: Europe's stringent management of the pandemic is revealed in mobility data. It remains to be seen whether greater stringency will prevent another bout of rising cases. With activity well below year-ago levels during the important European tourism season, we expect **the pain in Europe is likely to be greater than the U.S. for at least another two quarters.**

Four of Europe's five largest economies (U.K., France, Italy and Spain) implemented very stringent shelter-in-place mandates during the height of their respective COVID-19 outbreaks. In terms of mobility, those four countries saw citizens' mobile activity decline 75-90% year-over-year for the entirety of April and through the first half May. **Rebounds in mobility have been sharp in those countries in recent weeks, although overall activity lags that of the U.S.** The lower level of mobile activity in Europe is evidence of a greater economic hole to dig out of in the period ahead. **This challenge also occurs at a time when mobility in Europe is typically crucial to the economy – tourist season.**

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Interest Rates & Inflation

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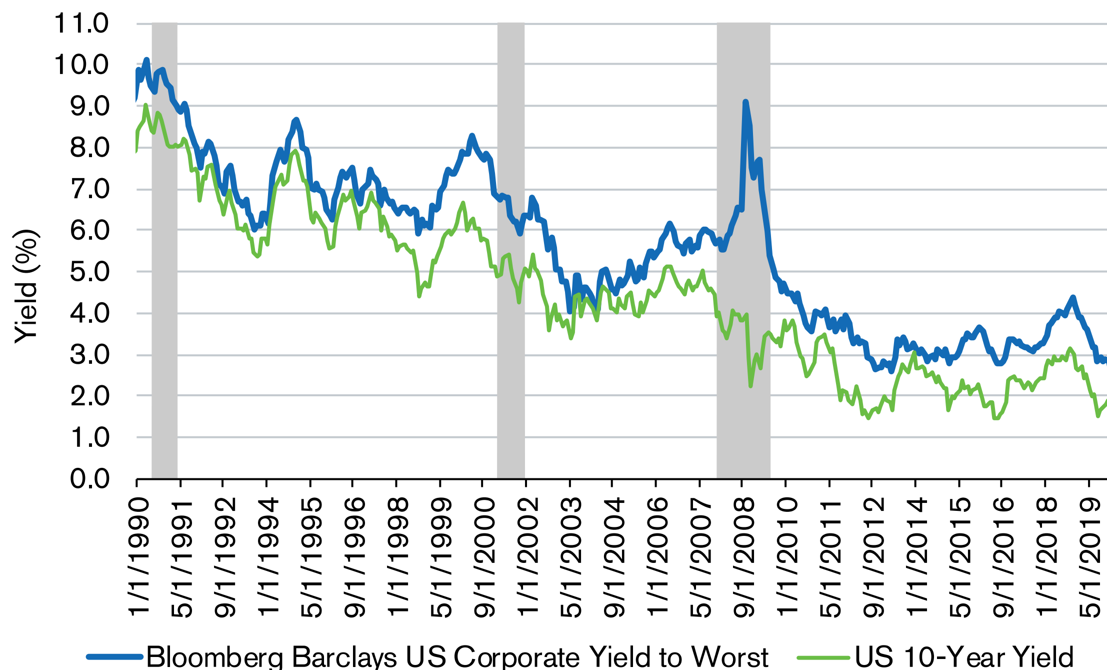
Corporate Bonds: Favorable Outlook as Economy Gains Traction

Portfolio Impact: With prospects for an economic recovery improved and with the Fed providing significant credit market stimulus, **we see solid return potential for Investment Grade credits.**



Source: Bloomberg, WestEnd Advisors

Corporate bond spreads have moved lower after widening in Q1 to the highest levels since the Financial Crisis. Fiscal and monetary stimulus, including the Federal Reserve's actions to inject liquidity into markets, have supported corporate credit performance.

That said, **corporate bonds yields are elevated relative to treasury yields, which have remained near all-time lows**. Investment-grade corporate bonds are currently yielding 4 times the amount of similar-duration treasuries. As the economic data improves and the recovery continues to take shape, we believe there is room for rates to move higher and for credit spreads to return to non-recessionary levels.

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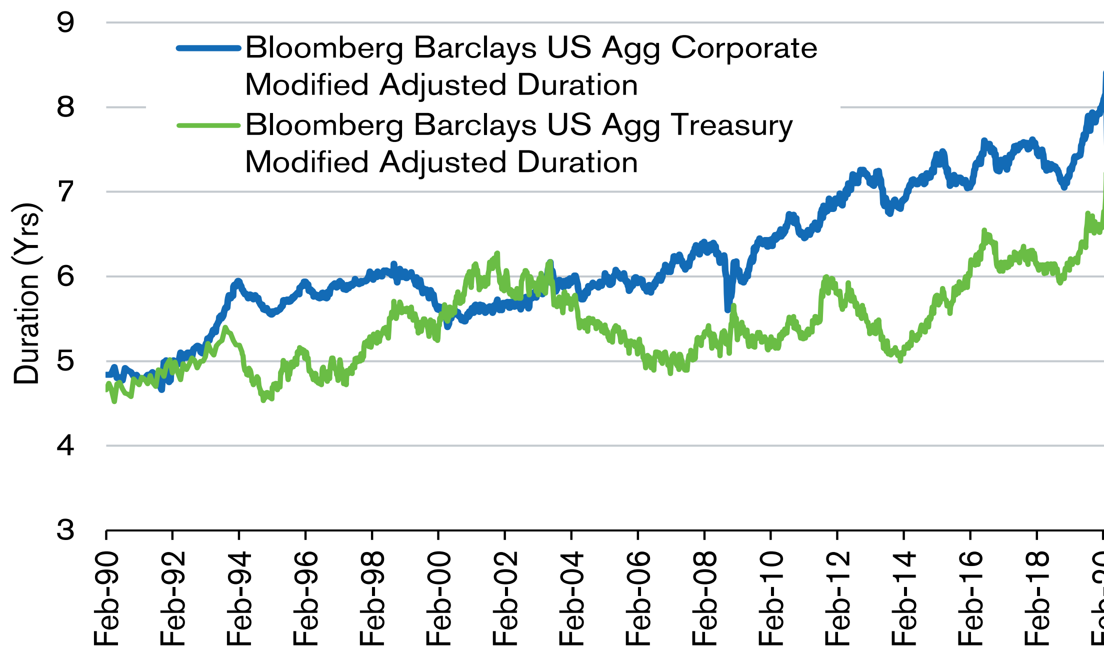
Bonds: Broad Bond Index Durations Elevated

Portfolio Impact: Bond durations are at all-time highs. **Investors should be aware of the risks of rising rates or outright interest rate volatility.** With corporate bonds yielding a spread greater than that pre-COVID, we prefer corporate, short-duration exposure.



Source: Bloomberg, WestEnd Advisors

Over the last 10 years, broad bond indices have seen a shift in characteristics, including maturity and duration. Lower bond yields and lengthening bond maturities have combined to drive investment-grade corporate and Treasury bond index durations to their highest-ever levels.

Investors who invest in broad-market bond exposure should beware of the risks of rising rates given the currently high durations. In particular, with rates at or near all-time lows, longer-duration bonds provide little compensation for the risk of interest rates rising or, as was seen in mid-March 2020, interest rate volatility. **We prefer short-duration, corporate investment-grade bond exposure as corporates generate higher yields than Treasuries and the short-duration subset is more insulated from interest rate volatility.**

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Footnotes & Disclosures

WestEnd Advisors is an SEC-registered investment advisor. Registration of an investment adviser does not imply any level of skill or training. The firm is an independent investment management firm, 100% owned by its active principals. WestEnd manages equity securities for individuals and institutional clients.

This report should not be relied upon as investment advice or recommendations, and is not intended to predict the performance of any investment. Past performance is not indicative of future results. It should not be assumed that recommendations made in the future will be profitable. The information contained herein is not intended to be an offer to provide investment advisory services. Such an offer may only be made if accompanied by WestEnd Advisors' SEC Form ADV Part 2. These opinions may change at anytime without prior notice. All investments carry a certain degree of risk including the possible loss of principal, and an investment should be made with an understanding of the risks involved with owning a particular security or asset class. The information has been gathered from sources believed to be reliable, however data is not guaranteed.

The Standard and Poor's 500 Stock Index includes 500 stocks and is a common measure of the performance of the overall U.S. stock market. The MSCI ACWI consists of 49 country indexes comprising 23 developed and 26 emerging market country indexes. The total return of the MSCI ACWI (Net) Index is calculated using net dividends. Net total return reflects the reinvestment of dividends after the deduction of withholding taxes, using (for international indices) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. The Bloomberg Barclays US Aggregate Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. The Bloomberg Barclays US Aggregate Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. An index is unmanaged and is not available for direct investment.

Any portfolio characteristics, including position sizes and sector allocations, among others, are generally averages and are for illustrative purposes only and do not reflect the investments of an actual portfolio unless otherwise noted. The investment guidelines of an actual portfolio may permit or restrict investments that are materially different in size, nature, and risk from those shown. The investment processes, research processes, or risk processes shown herein are for informational purposes to demonstrate an overview of the process. Such processes may differ by product, client mandate, or market conditions. Portfolios that are concentrated in a specific sector or industry may be subject to a higher degree of market risk than a portfolio whose investments are more diversified.

Holdings, Sector Weightings, and Portfolio Characteristics were current as of the date specified in this presentation. The listing of particular securities should not be considered a recommendation to purchase or sell these securities. While these securities were among WestEnd Advisors' strategies' holdings at the time this material was assembled, holdings will change over time. There can be no assurance that the securities remain in the portfolio or that other securities have not been purchased. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities presently in the portfolio. Individual clients' portfolios may vary. Upon request, WestEnd Advisors will provide a list of all recommendations for the prior year.