WESTEND Advisors

Economic and Market Commentary

Q3 2020

A Non-Partisan Vote For Sector Analysis

The COVID-19 pandemic and the U.S. election are near-term risks, but we expect economic growth will continue with market leadership shifting toward sectors and regions that benefit from cyclical tailwinds.

SUMMARY

- Economic recovery and expansion should continue, as fiscal support has provided a bridge for consumption into 2021.
- We believe risks from the COVID-19 pandemic and the U.S. election are widely understood and should ease in 2021.
- As earnings growth normalizes with economic recovery, we anticipate more economically sensitive equity sectors and regions will benefit from early-phase cyclical tailwinds.

Q3 2020 REVIEW

The economic recovery continued in Q3, despite more confirmed COVID-19 infections globally. The recovery's rapid trajectory has largely mirrored the sharp pandemic-induced recession, and certain key areas of the economy are now tracking at, or ahead of, pre-COVID growth trends. For example, Retail Sales (ex-food services) fell about 15% year-over-year in April, but by July were up over 5% year-over-year, about two percentage points greater than the average growth over the prior five years. Similarly, orders for non-defense capital goods (ex-aircraft) resumed year-over-year growth in August, reaching their highest absolute level in two years.

New cases of COVID-19 in the U.S. picked up in July, but outcomes generally improved with better treatment regimens and infections skewing toward younger patients with less risk of complications from the disease. Internationally, Europe saw a resurgence of cases in Q3, while many Asian countries generally seem to have kept infection spread under control.

Global equity markets continued a strong rebound in July and August, with the MSCI ACWI and S&P 500 both surpassing their February peaks. U.S. markets outperformed in the first two months of the quarter, led by the Consumer Discretionary sector, along with Information Technology, Communication Services, and Industrials—all relatively economically sensitive sectors. So called "FAMGA" stocks (an acronym for Facebook, Apple, Microsoft, Google, and Amazon) have been among the best-performers year-to-date, partly due to stable earnings from secular tech trends and their relative insulation from COVID impacts, but some of these stocks now have among the highest valuations in the market. Interestingly, the more defensive Consumer Staples sector had market-like returns during the Q3 rally, which we believe partly reflected a benefit from temporary demand for staples due to the pandemic. We trimmed U.S. Staples exposure in Q3 to fund more cyclical exposure.

In September, equity markets pulled back, led down by the U.S., including FAMGA, amid resurgent concerns over COVID-19 risks and increased focus on U.S. election uncertainty. Developed Europe (ex-UK), which had underperformed earlier in the quarter, outperformed along with emerging markets. Still, the MSCI ACWI returned 8.1% in Q3, despite September's pull back, and, given the large rally since March, some downside volatility is not surprising.

OUTLOOK

We anticipate the economic recovery will continue, with a likely normalization of earnings growth for many sectors and industries by 2022. This should support modest but positive equity returns over the next year, in our view, with sector and regional leadership continuing to shift toward areas of the market benefitting from more cyclical rather than secular economic tailwinds.

COVID and Election Risks
While these are near-term risks, we see positive fundamentals for many sectors longer-term.

The severe COVID-19 recession hit with incredible speed, but consumer income was not hit as hard as headline data might suggest. Although the unemployment rate spiked to a post-Great Depression high, the mix of job losses skewed toward lower wage earners, and fiscal stimulus *more than offset* aggregate income losses. By April, disposable personal income was 13% higher than in February, as stimulus checks and supplemental unemployment benefits were distributed. Stimulus and reduced consumer spending boosted the savings rate, which we believe provides a continuing bridge for the economy as it recovers. A gradual roll-off of stimulus has begun, but wages and salaries have rebounded (now down just 0.5% year-

over-year), while much of the fiscal support will run through year-end or into 2021 and could be extended in a lame duck session.

The COVID-19 pandemic remains a significant risk, but we believe a vaccine approval is likely by Q1 2021 with widespread availability in the U.S. in late Q2 or Q3 2021, which should mitigate its longer-term impact. Meanwhile, an increase in cases during the fall and winter seems likely, with more indoor activities, school/work re-openings, and increased testing at hospitals as patients present with flu symptoms. Flu patients, on top of COVID-19, could also stress the health care system. However, the COVID-19 death rate should decline as new infections skew toward younger patients with less co-morbidity, and we see economic headwinds easing as increasing comfort with safety protocols helps normalize behavior.

The U.S. election is another source of uncertainty for markets. Ironically, while still too close to call, the lack of a strong consensus on its outcome could limit the risk of a significant market-moving surprise (i.e., markets may be discounting many of the risks from a sweep by either party). Further, a disputed election would not be a surprise, and, while it could lead to a brief spike in market volatility, we expect the election will be decided this year. Finally, investors seem to fear corporate tax increases under Biden, but his plan would require a Democratic sweep, and we estimate his corporate tax hike would only reduce S&P 500 earnings by about 7% in 2021. We also think tax increases would be delayed and watered down amid lingering economic and labor market challenges.

Given near-term election uncertainty, we are primarily focused on the potential sector impacts of various election scenarios. For example, we view divided government as a positive for Information Technology and Communication Services, while a sweep by either party could increase risk. Both parties have issues with big tech firms, but their concerns and "solutions" differ, so we see major bipartisan efforts to breakup or heavily regulate tech as unlikely. In contrast, we view increased infrastructure spending as a rare area of bipartisanship, which could occur and benefit the Industrials sector under any election outcome. Health Care, meanwhile, could see increased patient coverage under a Democratic sweep, off-setting the risk of drug price caps. Please see our recent "2020 Election Preview: Focus on the Sector Impacts" for more details.

More generally, earnings in the U.S. are likely to vary by sector as the recovery shifts to a more normal expansion. The economically-sensitive Industrials sector, for example, should see significant earnings benefits from continued economic growth, as evidenced by improved machinery orders, increased rail and trucking activity, and strong consumer spending on durable goods. Our work shows that Industrials should have some of the strongest earnings growth of any sector in 2021. With a current market-like valuation, this makes Industrials attractive at this stage of the recovery. Similarly, Financials lagged this year, but we believe they will benefit from economic recovery, as loan loss provisioning tied to the pandemic should slow, and could be reversed as the assumptions that dictated large provisions prove overly pessimistic. Meanwhile, equity valuations remain a widely cited concern for investors, but we expect interest rates will remain low over the next few years, given the Federal Reserve's stated willingness to tolerate inflation above its historical 2% target. Low rates support higher absolute valuations by increasing the present value of future earnings.

In global portfolios, we have moved to an overweight of Asian emerging markets, where most major economies have contained and recovered quickly from COVID-19, and we view the sector mix as favorable in an economic expansion. While this move was funded by a modest reduction of U.S. exposure, the U.S. remains a significant overweight. We maintain an underweight to Europe, where COVID responses have been less effective, economic growth was already flagging pre-COVID, and Brexit risks persist.

Overall, we see significant opportunities in equity markets over the next year, even as we expect the market could move sideways as a whole. After first reducing expected portfolio risk as the pandemic spread, we have been increasing our active positioning to capitalize on opportunities ahead. We look forward to keeping you apprised of our evolving outlook and appreciate your confidence in WestEnd.

WestEnd Advisors Investment Team | October 1, 2020

Disclosures:

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The Standard and Poor's 500 Stock Index includes approximately 500 stocks and is a common measure of the performance of the overall U.S. stock market. The MSCI ACWI Index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI comprising 23 developed and 26 emerging market country indexes. An index is unmanaged and is not available for direct investment.

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