WESTEND Advisors

Economic and Market Commentary

June 14, 2021

Interim Update:

Inflated Fears - Focused on Trends Beyond the Current Distortions

Recent U.S. inflation data, distorted by the compressed pace of the COVD-19 recession and recovery, may *seem* to affirm widespread inflation fears. However, we expect inflation is likely to moderate as the economy shifts from recovery to expansion.

EXECUTIVE SUMMARY

- Recent U.S. inflation readings have been elevated, but, in our view, are distorted by the rapid pace of recovery and depressed readings a year ago.
- We believe many unusual factors elevating short-term inflation will moderate as the economy shifts from recovery to expansion.
- Fears that inflation prompts the Fed to tighten monetary policy too quickly (stalling the expansion) are overblown, in our view.
- Despite our outlook for contained inflation, we believe our portfolios' current positioning could actually benefit if inflation exceeds our expectations.

CURRENT INFLATION READINGS AND CONTEXT

- In May, the Consumer Price Index (CPI) rose 0.6% from April, and 5.0% year-over-year, and the Core CPI (ex-food & energy) rose 0.7% from April and 3.8% year-over-year.
- The May CPI readings also mark the anniversary of a deflationary period from March to May 2020, which increases year-over-year inflation due to base effect.
- Recent inflation has been driven by rebounding prices in industries facing pent-up demand, supply chain disruption, and/or labor shortages, including those related to transportation, hospitality, and leisure. *For example, in May, motor vehicles prices accounted for over half of the month-over-month rise in CPI, and, with gasoline, nearly half of the year-over-year increase.*
- Longer-term inflation expectations remain contained, in our view: market-based10-year inflation breakeven rates reached a recent high of about 2.5% in mid-May, in line with levels regularly reached in the early years of the 2010s expansion.

INFLATION OUTLOOK

Prices typically accelerate in an economic recovery, and then moderate as the cycle moves into mid-phase expansion. In our view, an unprecedented rebound of demand in the current recovery has exacerbated near-term supply/demand imbalances, and contributed to higher than normal inflation readings. We believe these inflationary imbalances are likely to ease in coming quarters.

In our view, sustained high inflation is unlikely without high ongoing wage growth. While average hourly wages have risen recently, our analysis suggests this is largely due to lower-paid jobs being more impacted by COVID layoffs. We believe average hourly wage growth should ease as more of these workers are re-employed, but this is an area that we will watch closely in the rapidly evolving post-pandemic economic backdrop. Also, productivity gains could offset some inflationary pressures from broader wage growth.

Other factors often cited as contributing to inflation are less likely, in our view, to play a role in *sustained* high inflation. For example, some commodity prices have spiked, but commodity inflation typically has limited flow-through to end-consumer prices. Further, recent money supply growth, while high, has largely been contained on bank balance sheets as excess reserves this cycle.

We currently see little to suggest that inflation is likely to reach 1970s-style rates (high single-digit or double-digits) this cycle. The Fed has clearly indicated it will tolerate higher levels of inflation in the short-term; thus, absent an unexpected continuation of high inflation, we see the Fed as unlikely to tighten too quickly.

PORTFOLIO POSITIONING

Our current portfolio positioning anticipates inflation near the Fed's 2% target in the intermediate term and modestly rising interest rates, but it could actually benefit if inflation exceeds expectations:

- Financials is our largest U.S. equity sector overweight, with an emphasis on bank exposure, which we believe will benefit from rising interest rates, whether due to rising real rates or inflation.
- We have completely eliminated exposure to the interest rate-sensitive U.S. Utilities and Consumer Staples equity sectors.
- In balanced strategies, we are currently underweight fixed income, and currently maintain shorter average duration than our benchmarks, which should limit interest rate sensitivity.

WestEnd Advisors Investment Team | June 14, 2021

Disclosures:

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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.

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DISCLOSURE UPDATE: On December 31, 2021, Victory Capital Holdings, Inc. ("Victory Capital") acquired WestEnd Advisors, LLC ("WestEnd"). WestEnd, an SEC-registered investment adviser, operates as an autonomous Victory Capital Investment Franchise. WestEnd's active principals continue to be responsible for managing the firm and its day-to-day operations.