WESTEND
Advisors

Economic and Market Commentary

Q3 2021

A Healthy Deceleration

Economies are moving from unprecedented recovery to steady expansion. We expect healthy market returns, but elevated volatility during the economic transition.

SUMMARY

- Healthy-but-decelerating economic growth in Q3 2021 was accompanied by mixed equity returns and rising market volatility.
- We see the U.S. economy entering an expansionary phase, with a pace of growth likely well below recent levels.
- Economic expansion should support positive equity returns, but we believe shifting economic trends and market volatility will make sector allocation key to investment outcomes in coming quarters.
- We see potential for rising interest rates in the U.S., which should have mixed equity sector impact and is a significant risk for bonds.

Q3 2021 REVIEW

After more than a year of rapid recovery from pandemic lows, the U.S. economy continued to grow at a very healthy pace in Q3 2021, but a wide variety of metrics, including consumer spending, housing, the labor market, and business sentiment, signaled slower growth during the quarter. Some of the slowdown was likely tied to the spread of the COVID-19 Delta variant, which appeared to impact consumer sentiment, travel spending, and various other data. The economic deceleration, however, also follows cyclical patterns typical of a shift from rapid recovery to expansion, particularly considering that this cycle has hit recovery milestones more quickly than prior cycles.

Equity markets also showed signs of a downshift in Q3, along with a notable increase in volatility. After five consecutive quarters of above-average returns between 6% and 21%, the S&P 500 returned just 0.6% in Q3. Sector performance was mixed in Q3, amid shifting growth patterns. Industrials, Materials, and Energy, some of the most economically-cyclical U.S. sectors, underperformed as economic growth slowed and supply chain constraints continued to limit some production. Sectors with a mix of cyclical and secular growth tailwinds generally outperformed, including the Information Technology, Financials, and Health Care sectors.

A range of concerns seemed to contribute to market volatility in the quarter. Economic fears early in the quarter tied to the Delta variant and questions on the timing of monetary policy tightening gave way to political uncertainty over the stimulus bills, tax hikes, and a potential government shutdown and/or default. However, regardless of the immediate catalysts, market volatility has historically been a hallmark of a shift from economic recovery to expansion.

Economic deceleration and market volatility were also evident internationally, and most notably in China. The initial economic recovery in China, boosted by above-trend global demand for goods and a strong rebound in production, has begun to revert to its longer-term trend. Meanwhile, China spooked global markets late in the quarter with regulatory crackdowns on some of its most successful industries (in the name of promoting "common prosperity") and the potential default of a highly-levered property developer, Evergrande. Chinese equities posted sharply negative returns in Q3, and other economically-sensitive emerging markets also declined. Developed international equity markets, on the other hand, were mixed in Q3. For example, Japan outperformed the U.S. as it made rapid gains in its vaccination rate and new political leadership prepared to take hold, while broad European markets performed in line with the U.S. in their local currencies, but had negative U.S. dollar returns.

In U.S. fixed income markets, longer-term interest rates declined early in the quarter, as concerns escalated over the Delta variant's potential economic impact. However, interest rates retraced earlier declines in the back half of the quarter as new COVID-19 cases peaked and the Federal Reserve signaled it is ready to taper bond purchases and is increasingly likely, in our view, to raise the Fed Funds rate in late 2022.

OUTLOOK

Shifting to Expansion: We expect U.S. economic growth should remain healthy, even as it decelerates to more normal expansionary levels.

We expect healthy, but slower U.S. economic growth over the next 6-18 months as a more typical expansionary economic phase sets in. The dynamic progress over the last year is consistent with an early-phase cyclical recovery. Given the degree of recovery to date, in addition to its rapid pace, it is normal that growth should decelerate.

We believe that U.S. real GDP growth in Q2 of 6.7% (annualized) likely marked peak growth for the year, but that in no way suggests recession is on the horizon. Headline GDP growth is forecasted to remain above a

5% annualized pace in the second half of 2021 and above 4% for full-year 2022. U.S. consumers remain exceptionally well positioned, in aggregate, with wage and salary earnings above pre-pandemic levels and over $2 trillion in above-trend savings accumulated during the pandemic. Measures of consumer spending, however, show that while services spending continues to rebound toward its pre-pandemic trend, goods spending has trended down from very elevated levels seen in the spring.

We also expect continued improvement in the labor market, which has added 4.5 million payrolls this year (through August) and over 17 million payrolls since the May 2020 low. While the August unemployment rate of 5.2% might once have been considered near "full employment," it obscures a depressed participation rate which, along with a record level of job openings, suggests there is still fuel for further employment gains.

We anticipate U.S. equity returns should be positive, and possibly above average, over the course of the expansionary phase of the economic cycle, though well below the explosive returns of the early-phase rebound. Key drivers of return, earnings growth and P/E valuation multiples, should be more muted in the expansionary environment. Over the past year, the positive impact on returns of strongly rebounding earnings has been partly offset by a significant reduction in valuation multiples. Looking forward, we expect lower overall earnings growth, but also anticipate that further multiple compression should be limited, in part because equity valuations now appear reasonable given the current low interest rate environment.

We do expect elevated volatility in the near term as markets seek to find their footing amid decelerating economic growth. Our analysis shows that the shifts from recovery to expansion have historically been volatile periods for equity markets, second only to recessions.

Positioning for Mid-Phase: Since April 2021, we have materially reduced exposure to highly cyclical U.S. sectors.

Given shifting economic tailwinds and likely market volatility, we believe sector allocation will be crucial moving forward. Large rebounds in earnings growth for some of the most economically-cyclical U.S. sectors appear priced into their valuations, and thus we believe those sectors could be at greatest risk of disappointing versus expectations as economic growth normalizes. As such, since April 2021, we have materially reduced portfolio exposure to sectors like Industrials and Energy. Instead, we are emphasizing sectors with secular earnings growth drivers, like Information Technology and Communication Services, which we expect will see less deceleration in revenue and earnings growth than other more-cyclical sectors as the economy normalizes. We are also emphasizing sectors with earnings growth opportunities specific to this cycle. For example, we believe Financials will benefit from a rise in interest rates as the Fed begins to tighten monetary policy, and we expect the Health Care sector to deliver steady earnings growth with upside from a rebound in elective procedures as the Delta wave of COVID-19 eases. Both Financials and Health Care also trade at significant discounts to the S&P 500 index.

Most international economies also appear to be at various stages of shifting from recovery to expansion, though not all cycles are in sync with the U.S. In our view, China is further along in its recovery, but faces ongoing fundamental challenges, including slow consumer spending and the Communist Party's push for more-even wealth distribution. In global portfolios, we have reduced emerging Asian exposure and moved to an underweight of China, while moving to an overweight of developed Asia, where we see greater near-term economic upside from factors like improved vaccination trends. We also see an improved risk/reward profile for Europe as its Delta wave ebbs, but still view it less favorably than the U.S. or developed Asia.

For U.S. fixed income markets, we continue to see a risk of rising interest rates, both from a potential increase in real interest rates tied to continued economic growth and from the potential tightening of monetary policy. Further, while we believe many recent inflationary pressures will moderate, we expect above 2% target inflation to continue for some time, which would also be supportive of higher interest rates. The short-term pullback in longer-term interest rates in early Q3 was counter to our outlook, and, in balanced portfolios, we took the opportunity to shift some corporate bond exposure from long-term maturities to intermediate maturities, reducing the expected interest rate sensitivity of the portfolios. We also remain underweight fixed income versus our benchmarks, with emphasis on shorter durations and investment grade corporate exposure.

WestEnd Advisors Investment Team | October 1, 2021

Disclosures: *This report should not be relied upon as investment advice or recommendations, and is not intended to predict the performance of any investment. These opinions may change at any time 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. Portfolio characteristics and/or allocations are generally averages and are for illustrative purposes only and do not reflect the investments of an actual portfolio unless otherwise noted. 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. While every effort has been made to verify the information contained herein, we make no representation as to its accuracy.*

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. An index is unmanaged and is not available for direct investment.

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' 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. 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.