

# Macroeconomic Highlights

**Q1 2022**

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# WestEnd Outlook Highlights

- We see the U.S. economy entering an expansionary phase, with healthy economic growth, but the pace of growth is likely to be well below levels of the initial rapid economic recovery.
- 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.
- Internationally, we believe the deceleration in global economic growth is likely to favor developed markets over emerging markets, which tend to be more economically-sensitive and face additional challenges in the current environment.
- We began positioning portfolios for expansionary mid-phase of the economic cycle in 2021 as the economic backdrop evolved:
  - In U.S. large-cap equity allocations:
    - 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 more-cyclical sectors.
    - We are also emphasizing sectors trading at a discount to the market with positive earnings outlooks, like Financials, which we believe will benefit from rising interest rates, and the Health Care sector which we expect to deliver steady earnings growth with upside from a rebound in elective procedures as the Delta wave of COVID-19 eases.
    - We maintain select cyclical exposures which should continue to benefit from the economic backdrop, while avoiding traditional defensive sectors like Utilities and Consumer Staples.
  - In global portfolios, we remain underweight international equities, as a whole, and recently reduced exposure to Emerging Asia, moving to an underweight of China, and shifted to an overweight of developed Asia, where we see greater near-term economic upside from factors like improved vaccination trends.
  - In balanced portfolios, we continue overweight equities and, within fixed income allocations, emphasize shorter duration and investment grade corporate bonds.

# U.S. Equity Sector Allocations

## WESTEND ETF STRATEGIES

Current large-cap U.S. equity sector allocation and avoidance\*

### Sector Allocations

- Information Technology
- Financials
- Health Care
- Communication Services
- Consumer Discretionary
- Industrials
- Energy

### Sector Avoidance

- Consumer Staples
- Materials
- Real Estate
- Utilities

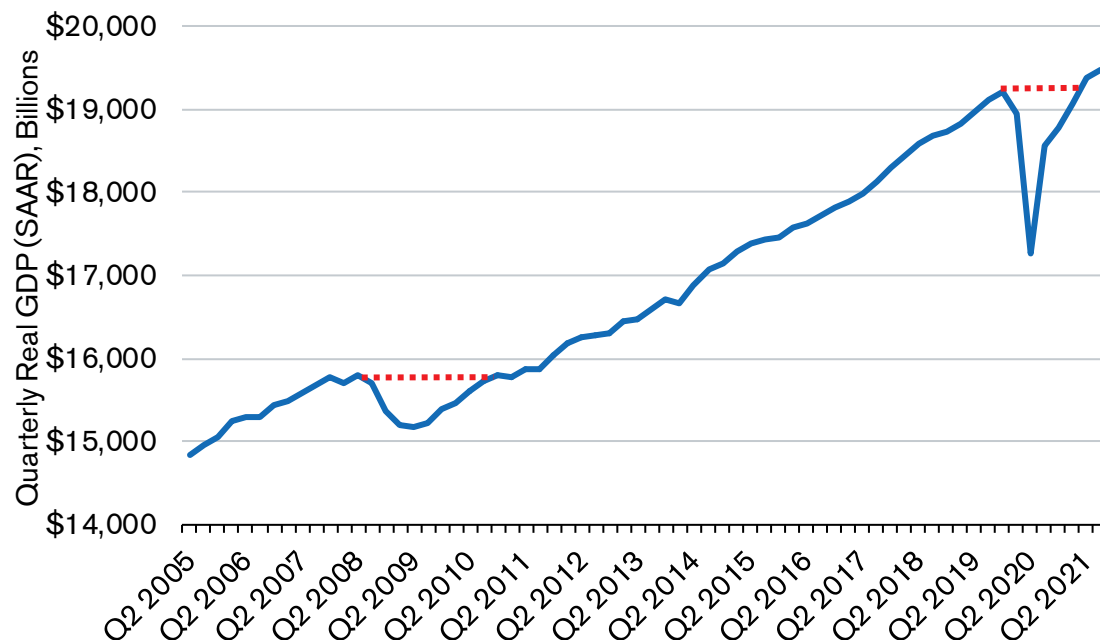
\* For illustrative purposes only. Allocation information as of December 31, 2021. Source: WestEnd Advisors.

# U.S. Economic & Market Backdrop

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# Rapid Recovery to Moderate as 2022 Progresses

## REAL U.S. GROSS DOMESTIC PRODUCT



Source: Bureau of Economic Analysis, WestEnd Advisors

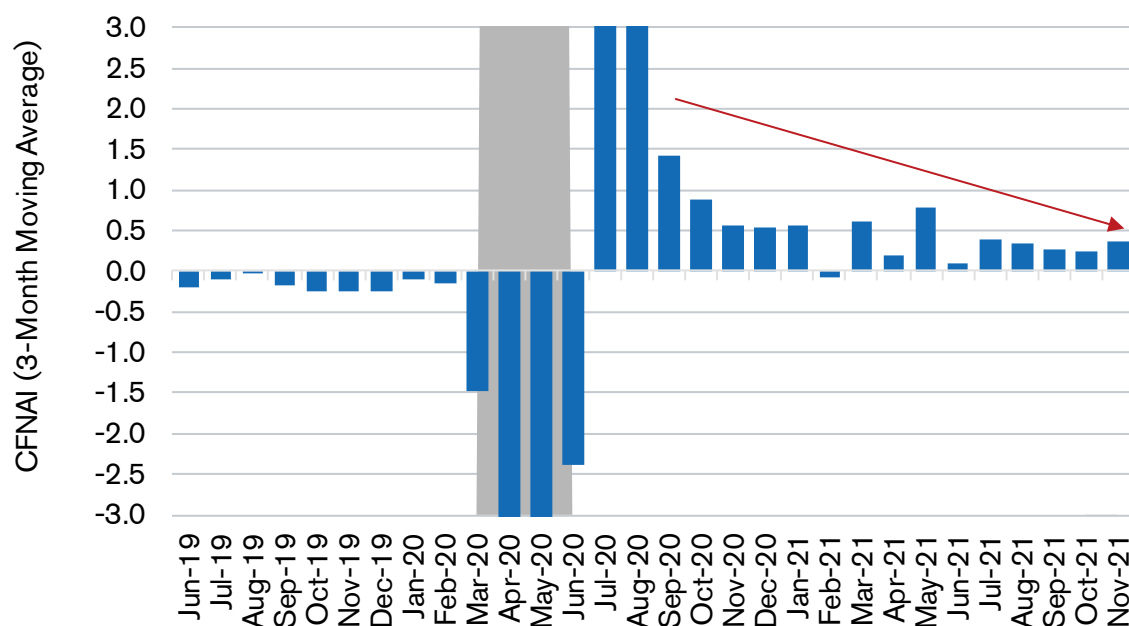
**Portfolio Impact:** Emphasis of economically-sensitive sectors like **Financials, Information Technology, Communication Services & Consumer Discretionary** is warranted, in our view, over more defensive sectors like **Utilities & Consumer Staples** given our outlook for the economic expansion to advance.

The U.S. economy has moved from the recovery to the expansion stage of the cycle, as real GDP surpassed the pre-pandemic peak in Q2 2021. The pace of economic growth slowed in the second half of 2021, and that trend is likely to play out further in 2022. Even as growth likely moderates, **we still believe the economic recovery will continue to progress, and thus an overweight of economically-sensitive sectors is appropriate.**

The shape of the U.S. economic expansion, including its durability, and identification of areas of economic strength will be key areas of focus for our economic analysis in 2022.

# Pace of U.S. Growth has Slowed, but Economy Remains Healthy

## CHICAGO FED NAT'L ACTIVITY INDEX SIGNALING DECELERATION



Source: Chicago Federal Reserve, WestEnd Advisors

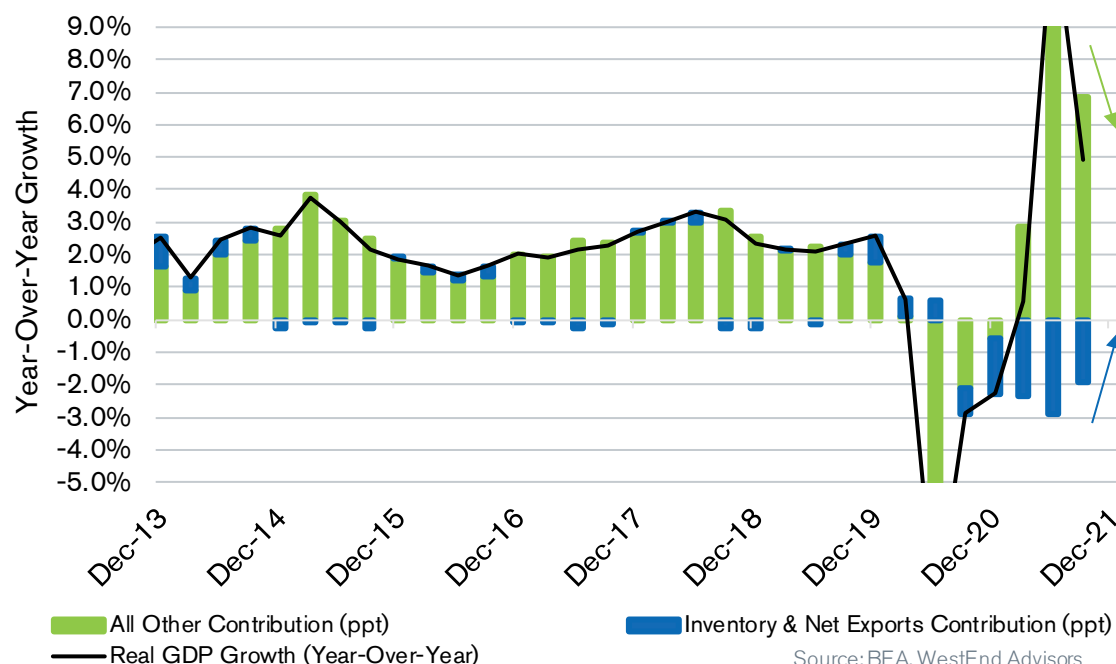
**Portfolio Impact:** The **deceleration in growth** for major economic readings continues to play out and has coincided with a **reemergence of market volatility**, as expected. We see exposure to **early-phase sectors** and **mid-phase sectors**, as well as an **overweight of equities**, as appropriate.

A wide variety of economic metrics, including consumer spending, housing, labor market and business sentiment, have shown signs of decelerating, even as economic activity remains healthy overall. **This slowdown in growth has been reflected in the Chicago Fed National Activity Index (CFNAI), which has trended lower from the elevated levels seen earlier in the recovery.**

That said, the CFNAI continues to signal an above-trend pace of growth, and we believe that pockets of improvement in certain areas of the economy, including trade, production, and nonresidential construction, could help offset slowing growth in areas like goods spending in 2022.

# Underappreciated Growth Drivers Heading Into 2022

## INVENTORY & NET EXPORTS DRAG ON GDP TO REVERSE



**Portfolio Impact:** Areas of economic activity that remained depressed in 2021, such as **travel, auto production, and inventories**, could rebound in 2022. This should **support earnings growth, and, by extension, support positive equity market returns**, in our view.

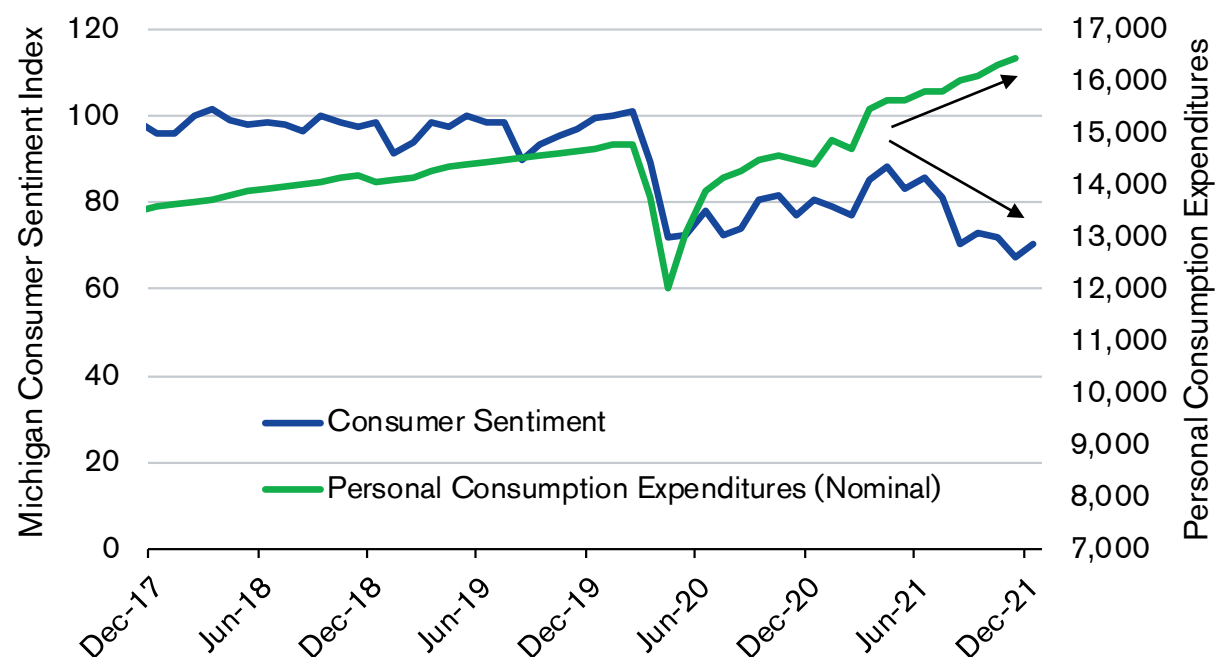
The economic rebound from the depths of the pandemic has been entirely driven by household consumption and business investment, in part, driven by record monetary and fiscal stimulus. As consumer and business spending growth slows in 2022, we believe **pockets of improvement in other areas of the economy, such as trade, production, travel, and nonresidential construction, could pick up the slack.**

Net exports and inventory drawdowns *detracted* ~3.5 percentage points from real GDP growth from Q3' 20 to Q3' 21. If that drag reverses in 2022, the **contribution to growth from net exports and inventories alone would equate to more than a full year of economic growth under a typical expansionary environment.**



# Consumer Spending Continues to Grow Even as Sentiment Slips

## CONSUMER SENTIMENT VS. CONSUMER SPENDING



Source: Bureau of Economic Analysis, University of Michigan, WestEnd Advisors

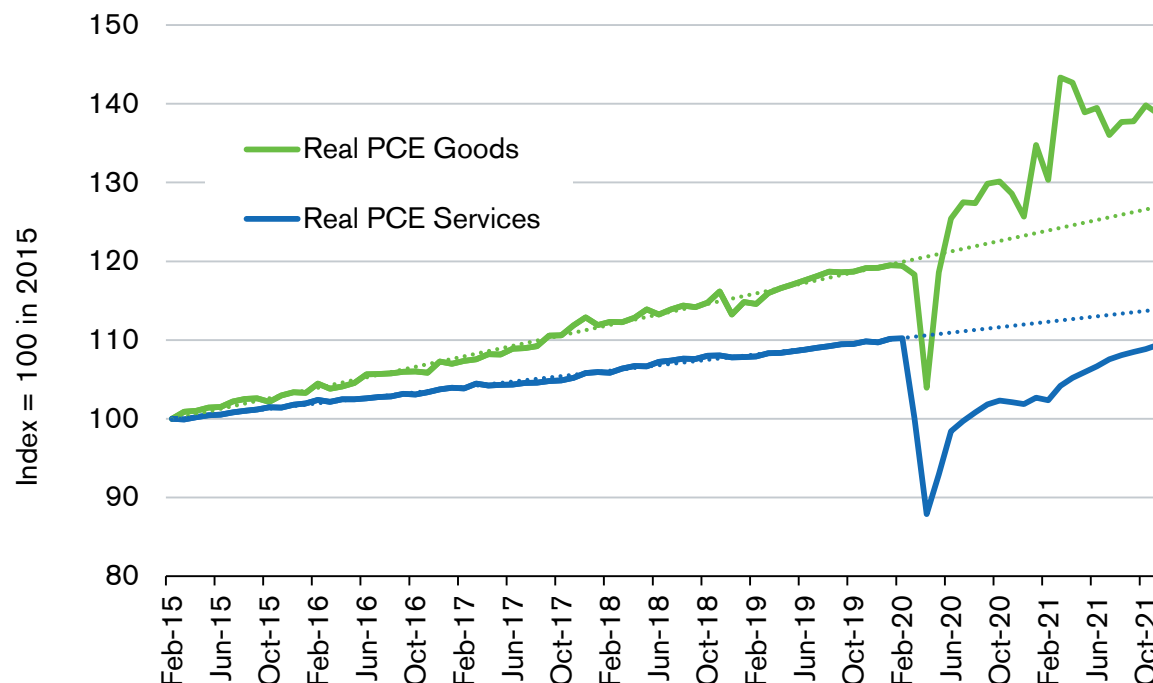
**Portfolio Impact:** Consumer sentiment readings fell in the second half of 2021, but **consumer spending continued to grow**. The consumer spending outlook continues to be positive, which supports allocations to sectors like **Consumer Discretionary** and **Communication Services**.

Our assessment of the health of the consumer places more emphasis on *what consumers do rather than what they say*. Consumer sentiment readings declined in the second half of 2021, in part because of concerns about accelerating inflation.

Despite these lower sentiment survey readings, which are 30% *below* pre-pandemic levels, **consumer spending, as measured by Personal Consumption Expenditures, is +11% *higher* than the pre-pandemic level.**

# Service Rebound Should Offset Softer Goods Spending

## NORMALIZED REAL GOODS AND SERVICES



Source: BEA, WestEnd Advisors

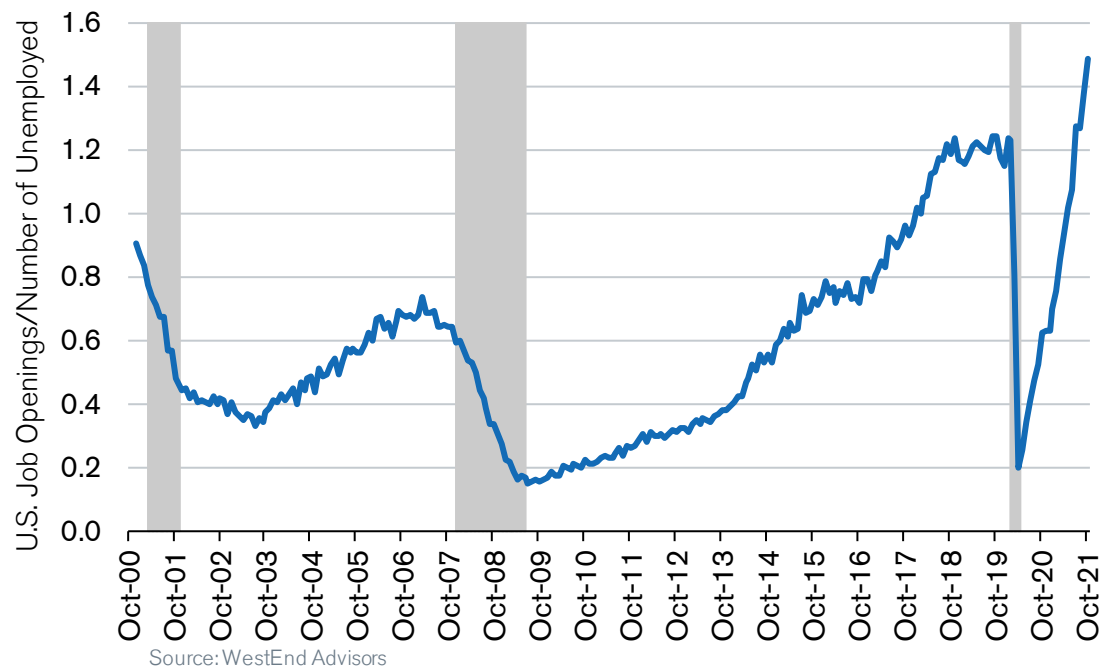
**Portfolio Impact:** We expect the goods spending binge to moderate in 2022, but **healthy personal income growth and significant accumulated savings should continue to support consumer spending** in the intermediate-term.

U.S. consumer spending on goods remains well above the pre-pandemic growth trend even after accounting for higher prices. **We expect that spending on goods will moderate in 2022**, in part, due to a shift towards spending on services.

**There is additional room for recovery in areas like travel and entertainment given that wages and salaries are 8.9% above pre-pandemic levels**, while nominal spending on recreation services is 8.7% below the category's pre-pandemic level.

# Strong Demand for Labor is Key Component of the Expansion

## JOB OPENINGS-TO-UNEMPLOYED RATIO

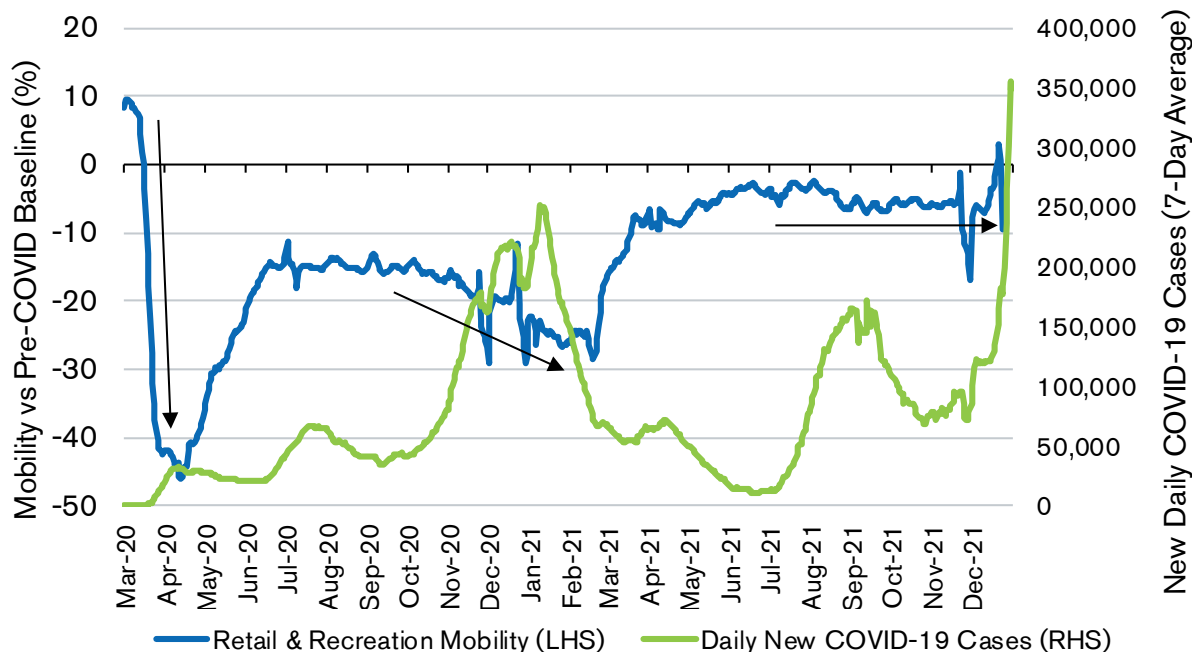


**Portfolio Impact:** Conditions are in place that we believe should deliver **additional labor market gains** in the quarters ahead, which should **support continued economic growth** but also drive a **shift in Fed monetary policy**.

The labor market is showing signs of a rapid recovery this cycle. The ratio of job openings-to-number of unemployed, for example, has reached a new high and surpassed previous late cycle levels. We believe **the healing of the labor market should support wage growth and provide the conditions for the Fed to move forward with raising interest rates in 2022.**

# U.S. Economy Developing Immunity to COVID-19 Pandemic

## RETAIL & RECREATION MOBILITY PROVING RESILIENT DURING DELTA WAVE



Source: Google, Bloomberg, WestEnd Advisors

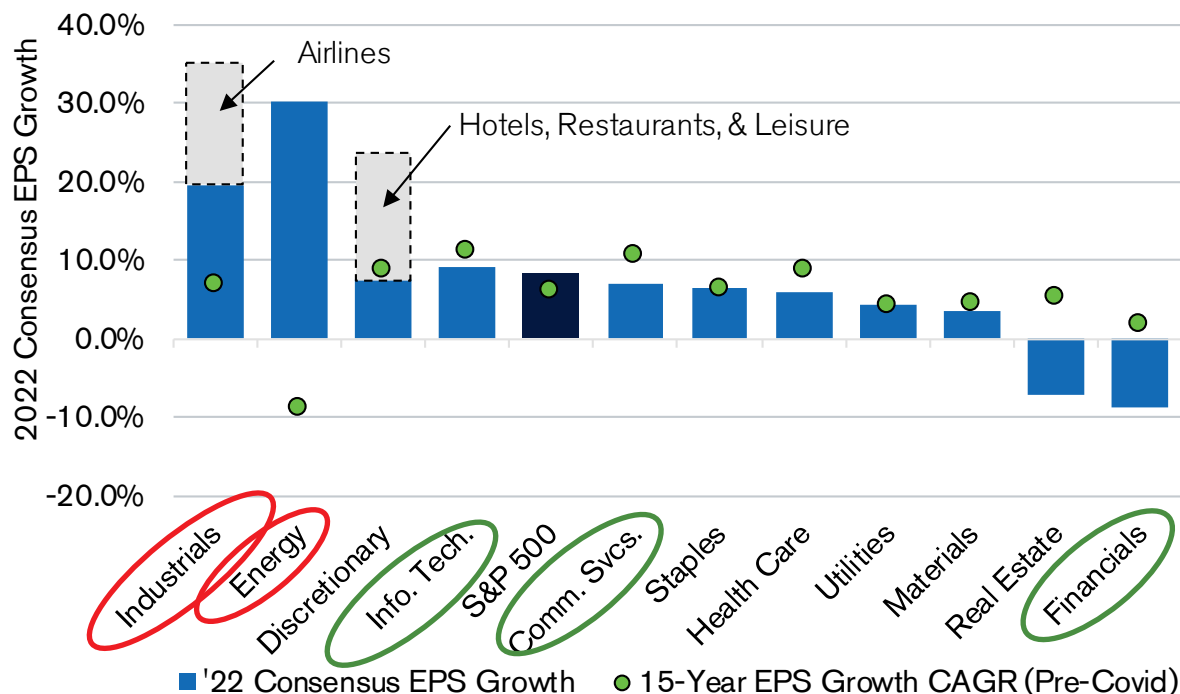
**Portfolio Impact:** Widespread vaccine availability, a higher level of immunity in communities should, and possibly less virulent variants of COVID-19, should in our view, limit the economic overhang created by the pandemic in the coming quarters.

The number of daily COVID-19 infections and hospitalizations surged higher in Q3 and Q4 due to the rapid spread of the highly-contagious Delta and Omicron variants, even as the number of fully vaccinated people in the U.S. climbed above 50%.

Importantly, **the economic damage caused by these variants has been much lower compared to previous COVID-19 waves**, as widespread vaccine availability has led to fewer limitations on businesses and an increased willingness by consumers to resume normal activities. As the chart above shows, **retail & recreation mobility has held up increasingly well with each new coronavirus wave**. While the Delta variant has made the herd immunity threshold more difficult to reach, we believe economic activity can continue to recover even if the virus becomes endemic.

# Secular Earnings Growth Increasingly Attractive as Cycle Develops

## 2022 EPS GROWTH ESTIMATES BY SECTOR



Source: WestEnd Advisors

**Portfolio Impact:** **Industrials** and **Energy** are among the strongest-growing sectors in 2022 as they rebound from lingering COVID-19 effects. However, sectors like **Information Technology**, **Communication Services**, and **Financials** have become more attractive, in our view, as they are poised to generate durable earnings growth during the next phase of the economic cycle.

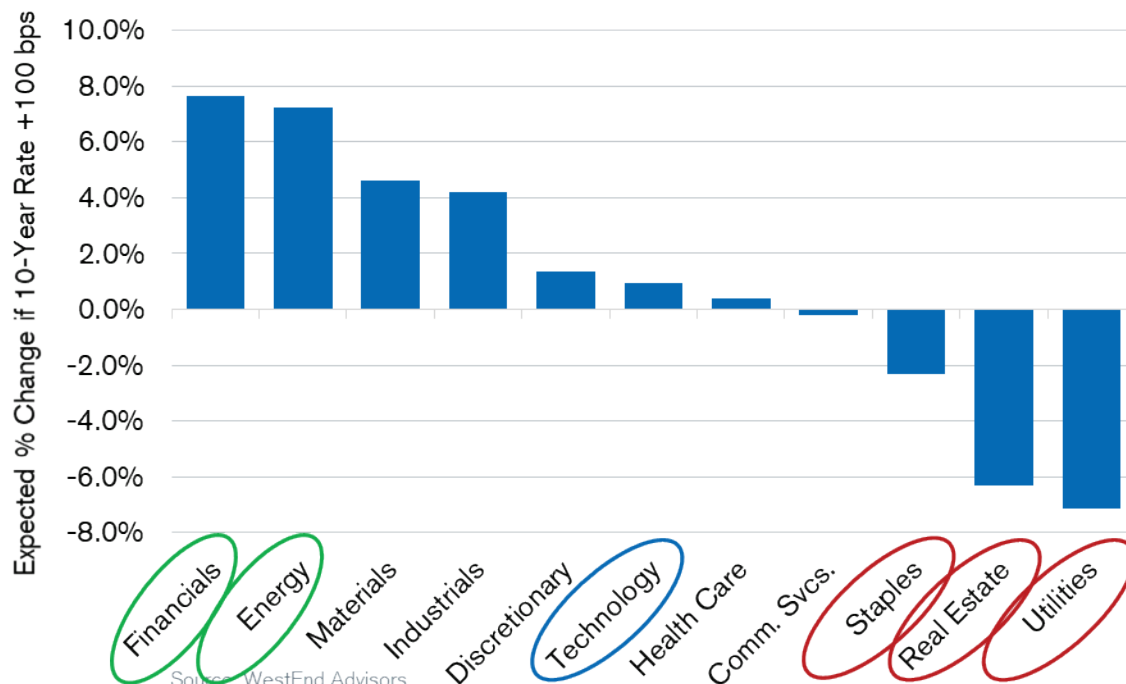
As is typical during economic transitions, we expect **earnings growth to vary significantly across market sectors in 2022**.

Economically-sensitive sectors are expected to deliver the strongest growth next year, primarily due to the release of pent-up demand in pandemic-sensitive industries such as airlines, travel and leisure, and energy.

While we fully expect activity in these industries to continue to rebound, **we are increasingly shifting our investment exposure to areas that are poised to do well in a post-pandemic-recovery environment**. Sectors such as **Information Technology** and **Communication Services**, which continue to benefit from secular growth tailwinds, have the potential to generate strong earnings growth even if the pace of economic growth decelerates. Earnings estimates for **Financials**, which benefitted from reserve releases in 2021, appear too depressed and, we believe, should rise as monetary policy normalization draws closer.

# Prospect of Higher Rates Doesn't Impact Sector Valuations Uniformly

## SENSITIVITY TO 10-YEAR INTEREST RATE



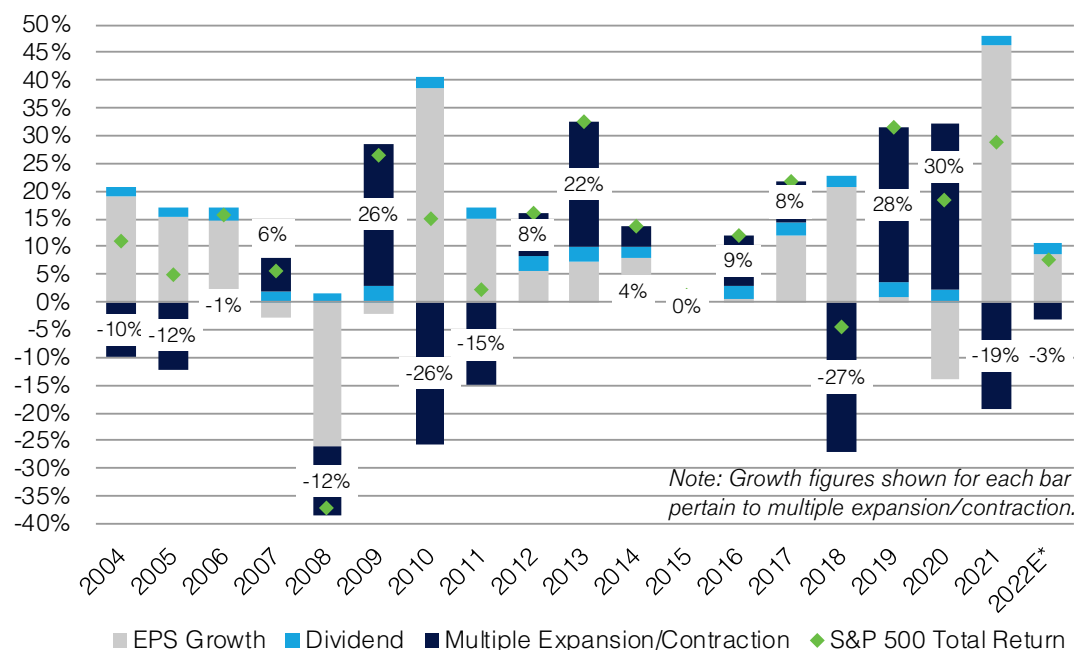
**Portfolio Impact:** Given our outlook for interest rate normalization, we remain **overweight sectors that tend to benefit in rising rate environments**, such as **Financials** and **Energy**, and continue to **avoid** the most interest-rate sensitive sectors, such as **Real Estate** and **Utilities**.

The P/E for the S&P 500 is elevated by historical standards, but WestEnd believes *interest-rate adjusted* equity valuations are attractive, given the low level of interest rates and the healthy growth and margin backdrop, and particularly given that **2022 S&P 500 EPS is now expected to be 43% above 2019 earnings**.

While equity valuations could become less attractive if interest rates rise, we believe **there is likely to be a significant degree of variation in how different sectors respond to higher rates**, as shown above. We **do not see interest rate normalization as a severe threat to valuations** for the early and mid-phase sectors to which we are allocated as long as the pace of the Fed's rate hiking cycle is moderate, as we expect.

# Expect More-Muted Equity Return Drivers in 2022

## CONTRIBUTORS TO S&P 500 TOTAL RETURN



\*Uses consensus '22 EPS growth as of 12/31/21. Assumes 7.5% total return in '22.

Source: WestEnd Advisors

**Portfolio Impact:** Although our 2022 return outlook for the S&P 500 contemplates lower returns relative to 2020 and 2021, **we believe sector dispersion will offer ample alpha generation opportunities** as earnings growth becomes a larger portion of equity returns. We also believe our sector allocations have us well positioned to take advantage of this performance dispersion.

The trailing price-to-earnings multiple for the S&P 500 fell nearly 20% in 2021 alongside a rapid rebound in earnings, which is a typical occurrence during economic recoveries. These moves in earnings and multiples, along with dividend yield, translated into a 29% return for the S&P 500 last year.

As the economy enters a more normal growth environment, we expect **equity market returns in 2022** to be driven primarily by **earnings growth, which will be partially offset by additional multiple contraction**. These are **normal market dynamics as the economy transitions to the middle stages of a cycle (see 2011)**.

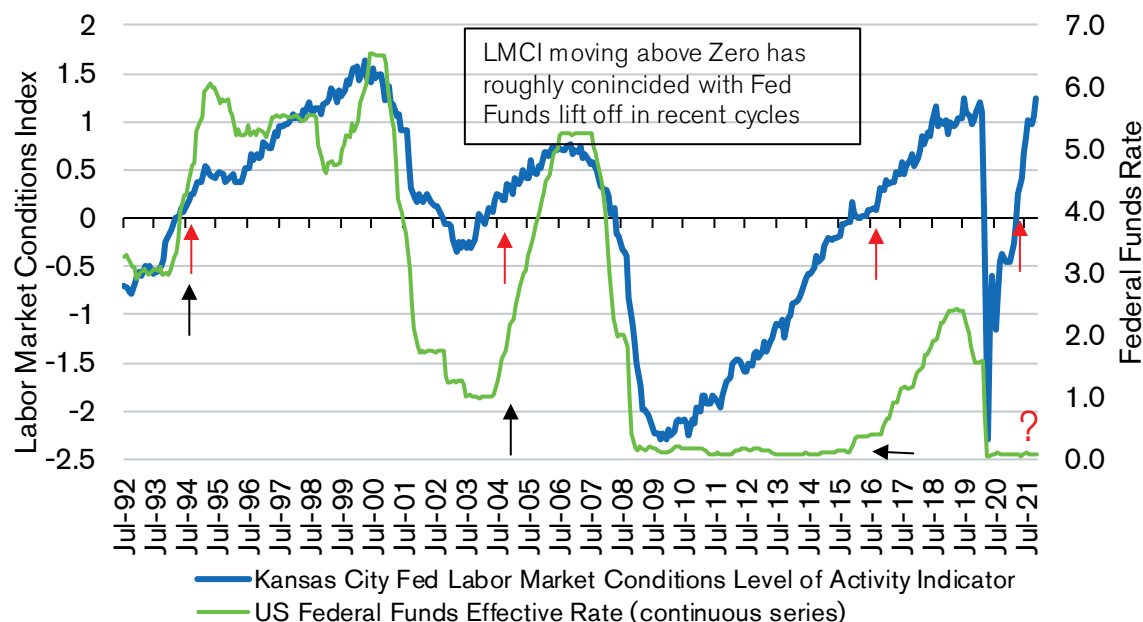
# U.S. Sector Outlook

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# Financials Sector Earnings to Benefit from Interest Rate Hikes

## LABOR MARKET CONDITONS HAVE REBOUNDED IN RECORD TIME



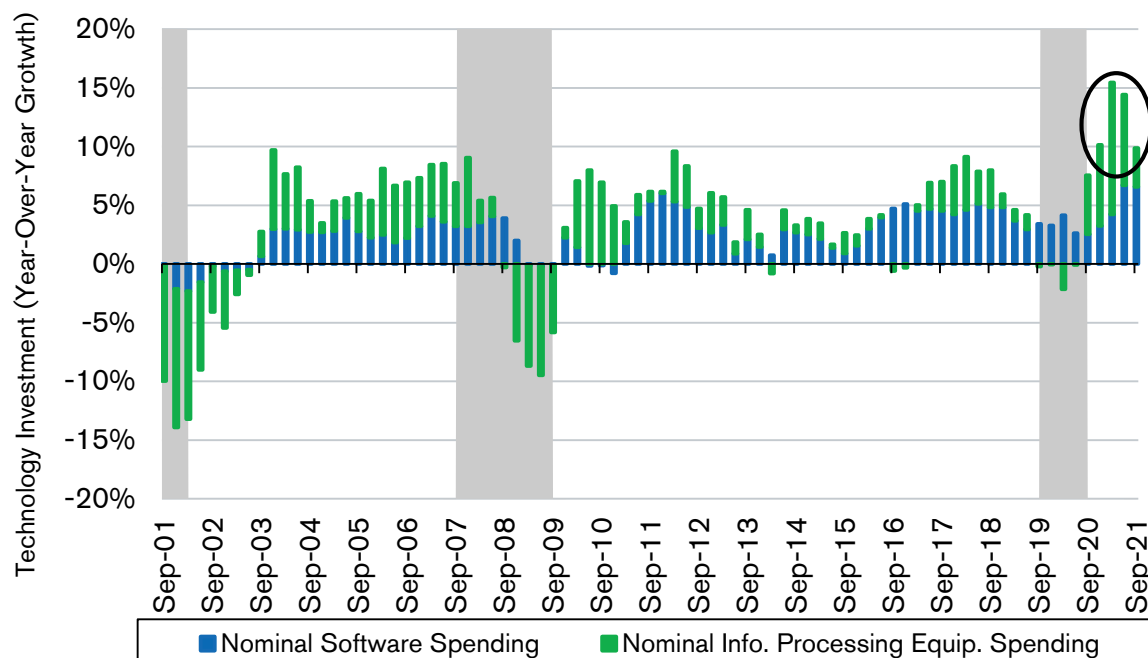
Source: Kansas City Federal Reserve, WestEnd Advisors

**Portfolio Impact:** The **Financials sector** is positioned well, in our view, to benefit from the next phase of the economic recovery. We believe the strong economic and labor market rebounds should support **monetary policy normalization**, which in turn should **lead to higher interest rates and above-consensus earnings growth** for Financials sector companies.

The U.S. economic recovery is likely to continue to progress, in our view. This should benefit economically-sensitive businesses like Financials, and banks in particular. **The labor market has made significant improvement, which we believe sets the table for the Fed to move from tapering to further normalization of monetary policy.** The chart above highlights that in prior cycles the Fed started raising the Fed Funds rate in close proximity to when the Labor Market Conditions Index turned positive (left axis). Today, the LCMI stands at 1.25. We believe this, in conjunction with a robust economic recovery and above 2.5% inflation readings, will put upward pressure on both short and long-term interest rates, which should be a **significant tailwind for Financials sector revenue and profits.**

# Tech Sector Well Positioned for the Next Stage of the Cycle

## TECH SPENDING GROWING JOINTLY ACROSS SOFTWARE & HARDWARE



Source: BEA, WestEnd Advisors

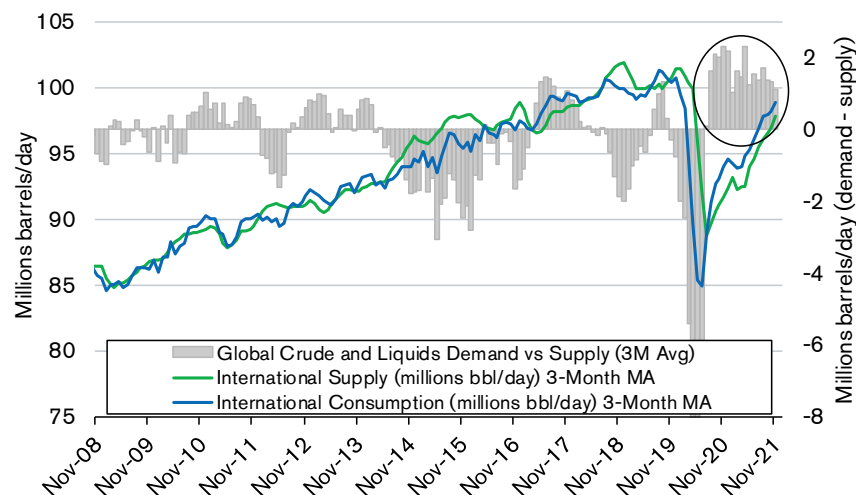
**Portfolio Impact:** As economic growth rates normalize in the shift to mid-phase, we believe the **Information Technology sector will see less revenue and earnings growth deceleration** than other economically-sensitive sectors, and thus we view significant exposure to the sector as appropriate.

Businesses and consumers have increasingly embraced digital platforms like cloud computing, eCommerce, digital payments and social media in recent years. We believe **the growing adoption of these services, as well as the hardware that supports them, means that sales growth for the Information Technology sector should exceed overall GDP growth for an extended period.**

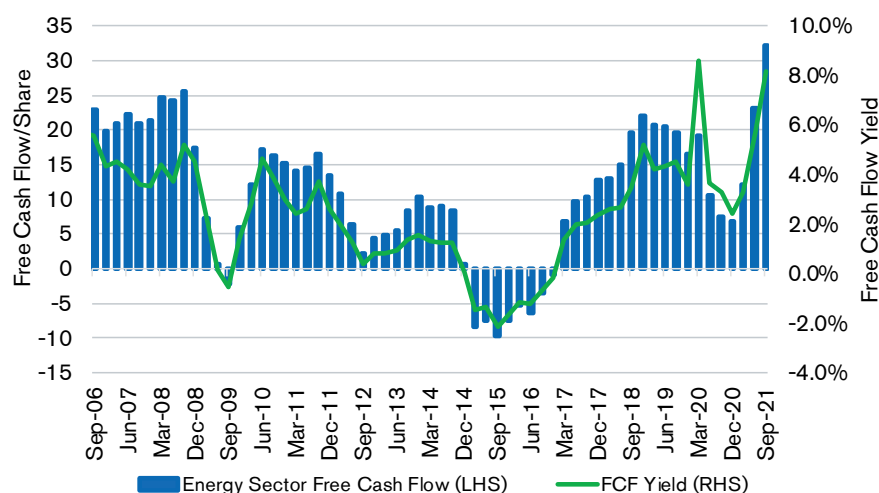
As shown in the chart above, growth across *both* software spending and tech hardware spending has reached double-digits for the first time in over two decades.

# Energy Markets More Balanced in 2022

## INTERNATIONAL LIQUIDS DEMAND VS SUPPLY



## CASH FLOW SURGE CREATES ATTRACTIVE ENERGY VALUATIONS



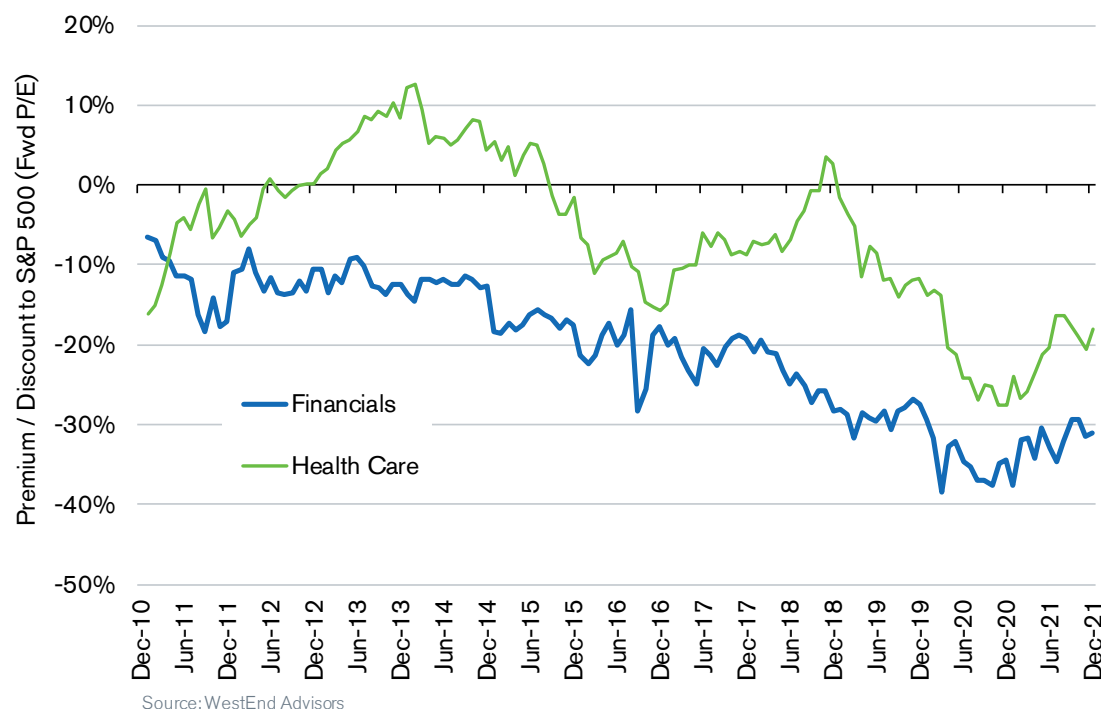
**Portfolio Impact:** Modest Energy sector exposure is appropriate, in our view, as the **risk/reward profile for the Energy sector has become more balanced**, cheap valuations remain, and there is the risk that this cycle runs hotter than previous cycles.

The rapid nature of the global economic recovery has supported oil demand, driven by rebounding production, trade, and travel volumes. While we expect global liquids demand to continue to recover toward the pre-pandemic peak in 2022, we also believe **oil & gas demand growth is likely to decelerate next year at the same time that more supply is set to come online**. This should leave the energy market in a more balanced state in 2022, after having been in a deficit for most of 2020 and 2021.

We continue to see attractive valuations in the Energy sector, which trades at the cheapest 12M forward P/E (~11X) of any sector. Furthermore, due to rising commodity prices and the industry-wide shift toward capital discipline, **Energy now trades at a near-record free cash flow yield**, on par with March 2020 levels (see bottom chart).

# Opportunities in Discounted Sectors in Modest Return Environment

## FINANCIALS AND HEALTH CARE P/E DISCOUNTS TO S&P 500



**Portfolio Impact:** As the economy moves forward in expansion, we expect investors are likely to **reward sectors with attractive combinations of growth and valuation.** We see the **Financials** and **Health Care** sectors meeting those criteria.

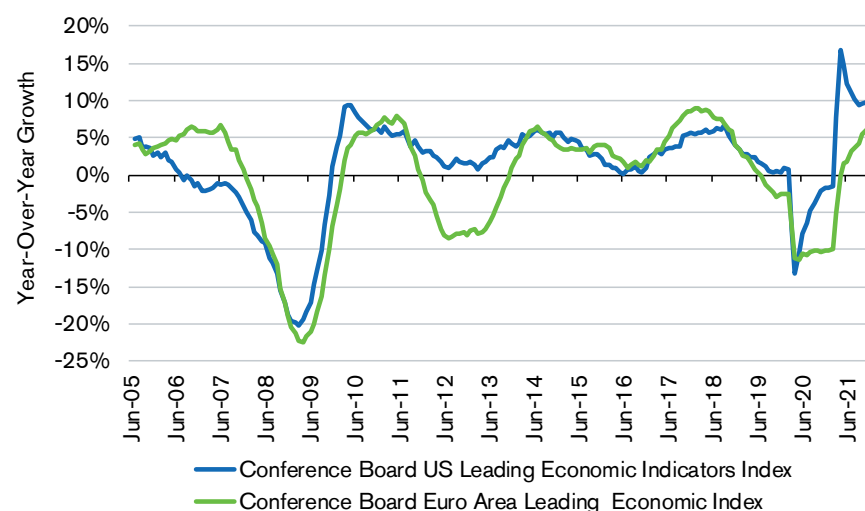
We see a **positive earnings picture** for the **Financials and Health Care sectors** in the period ahead. We expect normalization of monetary policy should provide a catalyst for the Financials sector earnings, and banks in particular, while Health Care companies should be able to deliver steady earnings growth even as economic growth decelerates. We believe these **positive earnings developments, together with attractive valuations, create the opportunity for these sectors to outperform** in our 6-to-18 month investment window.

# International Economic & Market Backdrop

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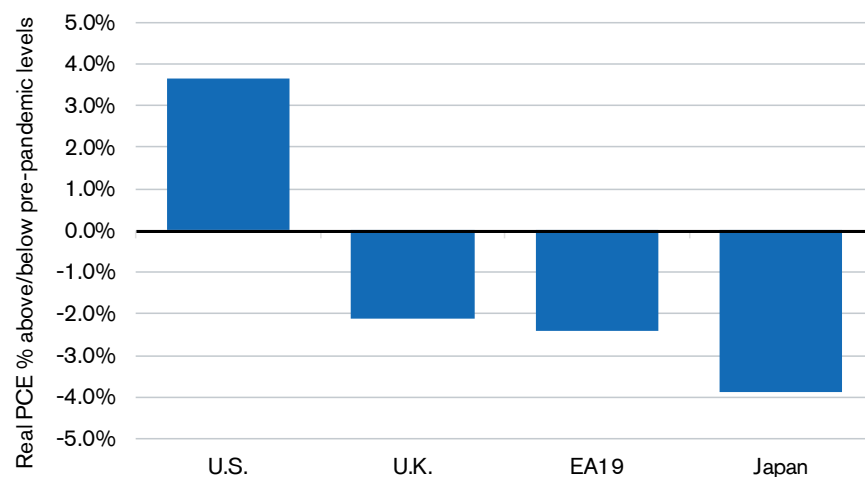
# Cyclical Progress Warrants Greater Allocation to DM

## EUROPEAN ECONOMIES IN RECOVERY PHASE



Source: Conference Board, WestEnd Advisors

## REAL PCE REMAINS DEPRESSED IN INTERNATIONAL DM



Source: WestEnd Advisors, BEA, Eurostat, ESRI Japan, UK ONS (As of 09/30/21)

**Portfolio Impact:** In our view, international developed economies are likely to benefit from recovery tailwinds in 2022, even as the global economic cycle continues to mature. We believe an **overweight allocation to Japan is warranted**, and have **increased our allocation to Europe and Developed Asia ex-Japan**.

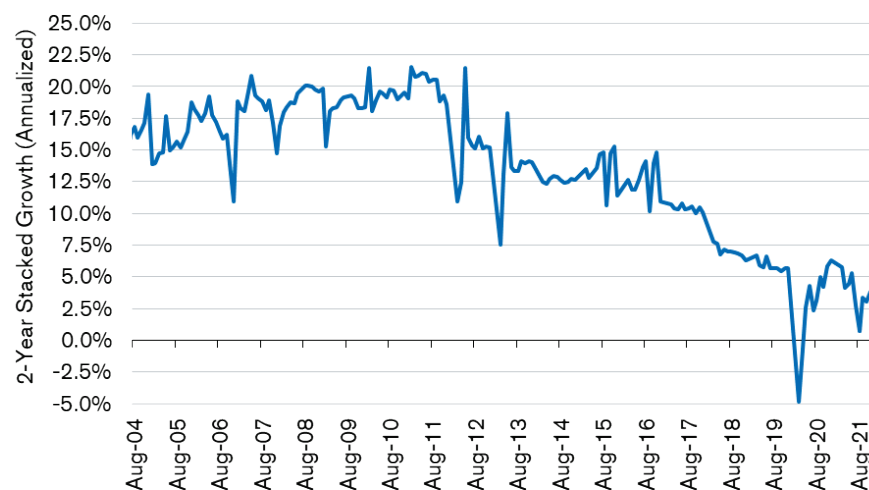
Europe and Japan have experienced slower recoveries than the U.S. due to lockdown measures associated with continued COVID-19 outbreaks. Looking forward, we believe these regions are likely to continue to rebound in 2022, with higher levels of community immunity, fewer restrictions, and healthy labor markets.

Personal consumption growth is an area of potential upside for these economies, as shown in the bottom chart. In **Japan, for example, we have seen a period of significant savings build-up due to Covid-19 restrictions**, which could provide fuel to Japan's spending upswing.

Furthermore, **valuations in international developed markets have become increasingly attractive** in our view. Japan, in particular, trades at a record-low forward discount to the U.S., even as consensus earnings growth looks too low, in our view.

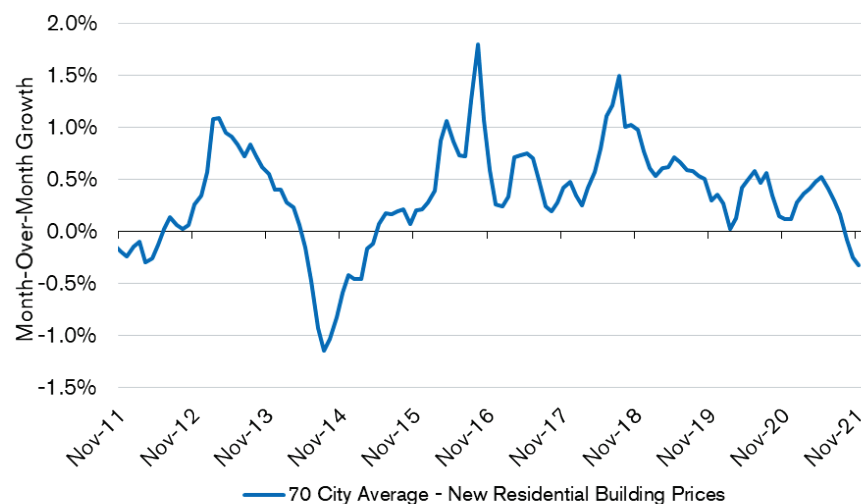
# China's Economic Growth Slowing While Regulatory Risks Rise

## CHINA RETAIL SALES % GROWTH (2-YEAR STACK)



Source: NBSC, WestEnd Advisors

## CHINA - NEW HOME PRICES DECLINING



Source: Bloomberg Intelligence, WestEnd Advisors

**Portfolio Impact:** Risks to China's short and long-term growth have become more acute with **higher levels of macroeconomic and geopolitical uncertainty**. We **reduced EM Asia exposure**, given China's large weight in the region, though we remain more upbeat on secular growth opportunities outside of China.

**China has decoupled from other major economies and is further along in its economic cycle.** Growth is now slowing as export demand peaks, the property sector slows, and the economy becomes more dependent on household consumption. Reemergences of COVID-19 and declining real estate values has impeded consumer spending and broader economic activity.

**The Chinese government is hyper-focused on removing excesses and balancing the economy.** A focus on regulation within areas that had prospered in the years leading up to COVID, such as Communication Services, Information Technology, and Consumer Discretionary, creates new impediments to earnings. This has weighed on multiples and, we believe, could present additional downside risks to earnings estimates in 2022 and beyond.

Recent policy easing has been limited in magnitude and, we believe, is unlikely to be as stimulative as in prior easing episodes, given the aforementioned focus on economic excess.

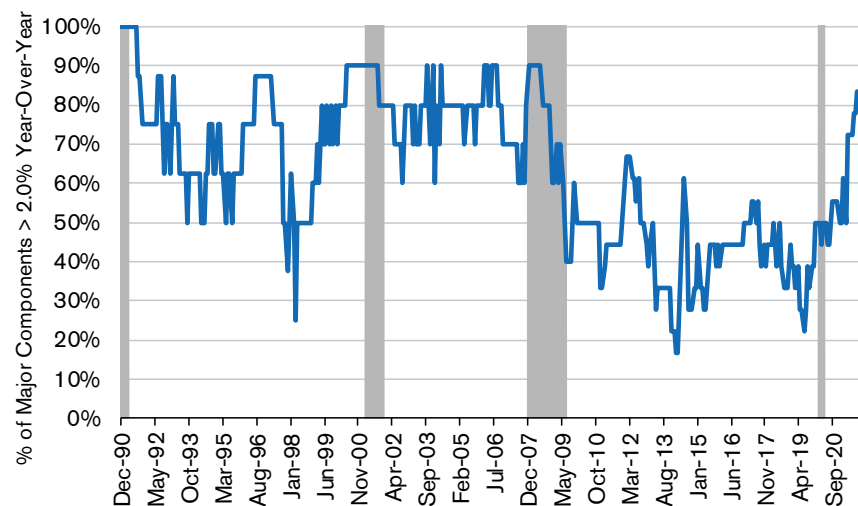
# Interest Rates & Inflation

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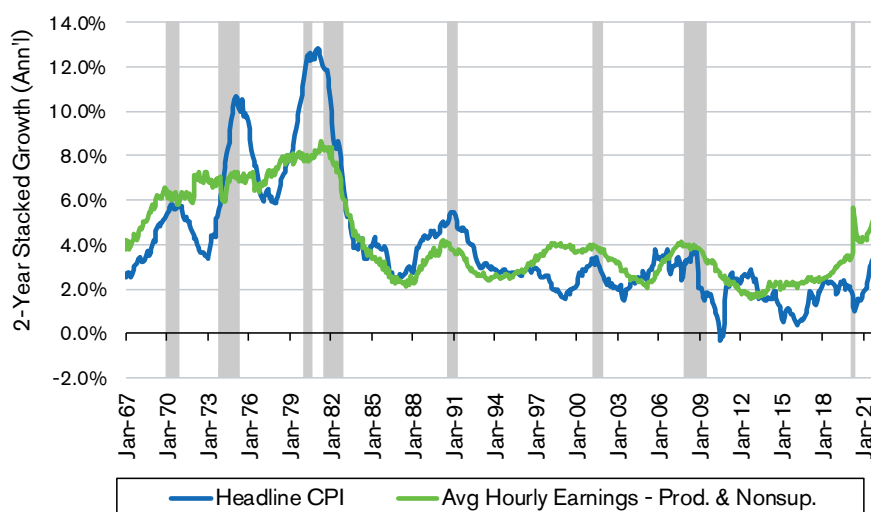
# Inflation Surge To Moderate, But Structural Pressures Emerging

## MAJORITY OF CPI COMPONENTS ABOVE INFLATION TARGET



Source: BLS, WestEnd Advisors

## CPI INFLATION & AVG HOURLY EARNINGS



Source: BLS, WestEnd Advisors

**Portfolio Impact:** We believe core inflation is likely to moderate in 2022 as many transitory pandemic effects fade. While this limits the risk of an inflationary spiral, we still expect CPI to stabilize above the Fed's 2% target, which should put upward pressure on interest rates and encourage the Federal Reserve to normalize policy.

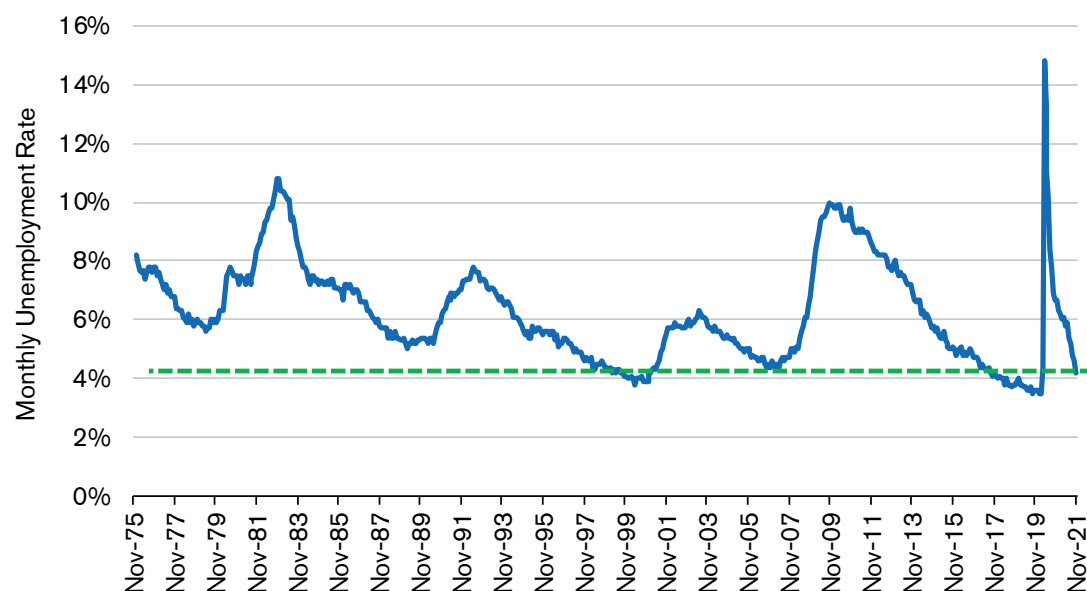
Transportation (Autos & Air Travel) price gains drove a significant portion of the ramp up in inflation in 2021. While we expect inflation in these areas to diminish, rising pressures in other areas are likely to keep inflation materially above the Fed's target in 2022:

**Housing & Shelter:** We expect housing costs, which are the largest consumer expense, are likely to continue to increase as higher rents and home prices flow through inflation calculations.

**Labor Costs:** In our view, higher wage growth, supported by a tightening labor market and lower labor force participation, is likely to come to the fore as the economy enters a mid-cycle environment. We believe this will warrant attention from the Federal Reserve. **Two-year average hourly earnings growth for production workers, which has historically had a strong relationship with headline CPI (R-Sq: ~70%), has risen to the highest level in four decades** (bottom chart).

# Strength of Economic Recovery and Magnitude of Labor Market Healing to Drive Monetary Policy Normalization

## U.S. UNEMPLOYMENT RATE HAS FALLEN THE FASTEST ON RECORD



Source: Bureau of Labor Statistics, WestEnd Advisors

**Portfolio Impact:** We expect interest rates to push higher in the quarters ahead. Given the prospect of higher long-term rates, **we continue to favor equities over fixed income and emphasize shorter duration securities within fixed income allocations.** In the event that inflation surprises to the upside, we believe our allocations to economically-sensitive sectors, such as Financials and Energy, should benefit.

Inflation has been an area of focus for us and other investors. That said, there is more to our interest rate outlook than just inflation. The **unemployment rate has fallen very quickly to a level that is in-line with or below the troughs in four of the last five cycles.** The strong rebound in economic activity, together with only a modest rebound in the labor force participation rate, has contributed to the record decline in the unemployment rate. We don't see these trends reversing in 2022, given an aging work force, which sets the stage for interest rate normalization.

## Footnotes & Disclosures

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. Registration of an investment adviser does not imply any level of skill or training. 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.