WESTEND Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

Q1 2022

Risks Rise, But Expansion on Track

The economic transition from rapid recovery to healthy expansion remains on track, in our view, despite market volatility and an uptick in certain risks. We have continued to adjust portfolios for the evolving cycle.

SUMMARY

- We see continuing cyclical progression toward a healthy-but-slower-growth economic expansion.
- Economic and geopolitical risks have increased over the past quarter, but they should not derail economic growth, in our view.
- Market volatility, while recently compounded by risks specific to this cycle, is normal in the shift from recovery to expansion.
- We are emphasizing parts of the market that should benefit, in our view, from continued economic growth and the underlying strength of consumption and business investment.

Q1 2022 REVIEW

Market volatility picked up sharply in Q1 as investors digested a range of risks, from the COVID omicron wave and monetary policy rate hikes to Russia's invasion of Ukraine and related energy price spikes. U.S. equities saw a correction of more than 10%, but rebounded somewhat in late March, with the S&P 500 ending the quarter down just 4.6% on a total return basis. The U.S. Energy sector outperformed sharply, up about 39%, as oil prices surged. The Financials sector outperformed, likely benefitting from rising interest rates, but was still down for the quarter. Information Technology and Communication Services were among the worst-performing U.S. sectors in Q1, as their above-market valuations contracted amid rising market uncertainty. International equities also generally underperformed, with Europe briefly dipping into bear market territory before partly recovering in late March. U.S. fixed income returns were negative across virtually all maturities and credit types, as inflation stayed high, investors priced in an increasing number of Fed Funds rate hikes for 2022, and the Fed began tightening.

Economic trends were relatively stable in Q1, compared to the volatility of markets, as the global recovery continued its cyclical shift from dynamic recovery to more trend-like expansion. In the U.S., job growth continued to average above half a million new jobs per month. Real (inflation-adjusted) consumer spending grew at 6.9% year-over-year in February, more than twice the average pace during the 2010s expansion, but slower than its recent recovery pace. International economic data was more mixed, but continued to shift from recovery to expansion across most regions, in our view, even as Russia's invasion of Ukraine threatened energy supplies in Europe.

Overall, we view Q1 2022 as a period when geopolitical events and an uptick in risks clouded healthy economic trends. We expect elevated market volatility as an economic cycle decelerates into an expansion, but we did not anticipate the degree of volatility that occurred in the face of the largest military assault in Europe since World War II. Nonetheless, we believe investors will shift their focus from headlines back to fundamentals as the economic cycle progresses.

OUTLOOK

We continue to see the global economy as healthy, overall, and in transition from rapid recovery to more trend-like growth. While there are risks from issues such as inflation in the U.S., elevated energy prices more broadly (tied, in large part, to the Russian invasion of Ukraine), and Federal Reserve monetary policy tightening, we do not believe these are likely to derail the economic expansion.

U.S. Economy and Markets: We expect economic growth to continue in the U.S. through 2022, even as growth decelerates toward its longer-run expansionary average. We see a mix of consumer and business strength driving continued growth. Real personal income is about 3% above its pre-COVID level (despite elevated inflation), and higher frequency data still indicate the economy remains on a positive trajectory. Initial jobless claims fell to historic lows and OpenTable restaurant traffic rebounded to pre-COVID levels in the back half of Q1 as COVID-19 cases declined. Positive labor market trends and robust household balance sheets should continue to support healthy (but decelerating) consumer spending growth in the coming quarters. Similarly, corporate profitability is high, balance sheets are healthy, and both nominal and real interest rates remain low by historical standards.

Within our positive outlook, we do recognize that some risks have increased. While the Russian invasion of Ukraine has dominated headlines over the past month, we see its impact on the U.S. economy as limited. Russia accounted for less than 1% of total U.S. trade in

2021, though follow-on impacts from energy prices and further supply-chain disruptions for certain industries extend sources of inflationary pressure and present a particular headwind for lower-income consumers. Inflation is likely to remain above the Fed's 2% target, and while we believe inflation should start to ease from current levels, the Federal Reserve is expected to continue raising interest rates throughout the year. We see this, in part, as a normal marker of the economic cycle's progression, but if the Fed meets or exceeds market expectations for the equivalent of eight more quarter-point hikes this year, it could prove to be the most serious risk for the U.S. economy.

That said, we believe the Fed could actually undershoot market expectations. The Fed is sensitive to the risk of inverting the yield curve, which could be seen as signaling or even causing a recession. Potential risks to the economy from the Ukraine invasion (while limited in our view) and softer economic data later in the year as the cycle progresses could provide cover for the Fed to slow its rate hikes. Despite recent focus in the financial press, we do not see the current state of the yield curve as a material issue. While some measures of the yield curve have edged in and out of inversion recently, the ends of the curve are far from inverted, making Fed rate hikes less likely to lead to broad inversion in the near-term. Further, yield curve inversion has not historically meant immediate recession, and we see a low probability of recession within our 6-to-18 month investment horizon.

Energy prices are also a risk for the U.S. and globally, but oil prices could ease materially if there is some resolution on Ukraine or a significant oil supply response. Portfolios benefitted from U.S. Energy sector exposure during the run-up in energy prices, and a recent portfolio rebalance allowed us to reduce risk from the position going forward by trimming back to our current target weight.

Adjusting as the cycle evolves: We have eliminated U.S. Industrials and overweighted Information Technology, modestly reducing economic cyclicality.

Given the ongoing shift to slower-growth expansion, we have adjusted various active portfolio exposures for the evolution of our outlook. We have eliminated U.S. Industrials exposure, which faces headwinds from slower growth and margin pressure tied to higher input and labor costs. We have also overweighted Information Technology in the U.S. We believe continued technology capex spending is likely as the tight labor market increases the incentive for business investment to enhance productivity. Further, a roughly 4-point reduction in Information Technology's P/E multiple in Q1 eased valuation concerns that had led us to avoid an overweight in 2021. Overall, we are emphasizing U.S. sectors with a mix of positive cyclical and secular earnings growth drivers, and avoiding more defensive and interest rate-sensitive sectors.

In **fixed income** markets, we continue to see a relatively poor risk/return profile, particularly for Treasury bonds, which offer low absolute yields. However, the rise in interest rates in Q1, as investors priced in an increasing number of Fed rate hikes, may reduce the risk of additional sustained upside to rates. Further, as we see little chance of U.S. recession in the near-term, and given very strong corporate profitability and balance sheets, we believe the risk of corporate defaults is very low. Given this backdrop, in balanced portfolios, we have taken advantage of wider corporate spreads amid market volatility to shift exposures from intermediate Treasury bonds to short-term high-yield credit, and we extended the duration of investment grade corporate bond exposure. These moves have increased the overall yield on portfolios and modestly extended duration, though we maintain a shorter duration (less interest rate sensitivity) than the benchmark.

Internationally, our broad view has not shifted much over the past quarter, despite geopolitical issues. We continue to favor developed markets over emerging markets as global economic growth decelerates. Further, we remain underweight Europe, where we see the most risk from the Ukraine crisis, particularly given Europe's relative dependence on Russian energy commodities.

Conclusion: We see continued opportunity in select areas of the markets as the economic cycle progresses, and we continue to evaluate evolving risks, both those typical of cyclical progression and those unique to this cycle. As always, we will adjust portfolios as appropriate for the opportunities and challenges we see ahead.

WestEnd Advisors Investment Team | April 4, 2022

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.

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.