WESTEND
Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary
Q2 2022

Cyclical Progression, Tactical Evolution

We see rapid progression of the global economic cycle, with certain fundamental areas of strength but also rising risks. As our outlook evolves, we continue to position portfolios to balance risks and opportunities in a mid- to late-phase economic backdrop.

SUMMARY

- While economic expansion should extend into 2023, U.S. growth is slowing, and we see new risks from a more aggressive Fed.
- Across portfolios, we have reduced economically cyclical U.S. exposure and added to mid- and late-phase sector exposure.
- In global portfolios, we continue to emphasize developed markets, and particularly Asia, where Japan appears well positioned.
- We see reduced risk of upside to longer-term interest rates and, in balanced portfolios, have increased fixed income allocations, lengthened duration, and added to Treasury exposure.

Q2 2022 REVIEW

The second quarter was a challenging period for financial market performance. U.S. equity and fixed income markets both posted negative returns as headline inflation and interest rates continued to move higher. Recessionary fears tied to tightening U.S. monetary policy escalated in June, as certain hotter-than-expected aspects of the May CPI reading were followed by a 75 basis point rate hike, which exceeded the Fed's prior guidance.

The S&P 500 index returned -16.1% in Q2, pushing into bear market territory with the index down -21.1% from its January 3rd peak. This represented its worst 1st half performance since 1970. The defensive Consumer Staples, Utilities, and Health Care sectors outperformed in Q2 amid recessionary fears, along with Energy as elevated oil prices boosted earnings expectations for the sector. International equities also declined sharply in Q2, but outperformed the U.S. Emerging markets outperformed in Q2 after lagging in Q1. Treasury and U.S. corporate bond prices fell in Q2, as a continued rise in interest rates drove the worst six-month bond performance in at least four decades.

In contrast to market volatility, many economic fundamentals remained generally sound, despite elevated inflation and a negative Q1 GDP print due to drags from inventory and trade. The unemployment rate remained near record lows at 3.6%, with nearly two job openings for every unemployed person according to the BLS. Double-digit year-over-year growth in aggregate wages and salaries growth pushed consumers' disposable income to a new record (excluding periods of fiscal stimulus), and consumer balance sheets remained flush with trillions in excess savings accumulated during the pandemic. Similarly, U.S. businesses continued to generate record profits, and S&P 500 companies have the lowest leverage profile in at least three decades.

Nonetheless, signs of economic deceleration continued, including declines in spending on consumer durable goods and private non-residential construction. Additionally, rising short-term interest rates and falling stock prices contributed to monthly declines in the Conference Board's widely-followed Leading Economic Index®.

OUTLOOK

Slowing growth
While key parts of the economy remain strong, we see signs of slowing.

The U.S. and global economic cycles continue to progress rapidly. While we expect the U.S. economic expansion to likely extend into 2023, we have seen, as anticipated, signs of slowing growth in economic data. In addition, we believe the Federal Reserve's recent shift toward more aggressive monetary tightening has exacerbated risks that the economic cycle could progress toward a late-phase slowdown more rapidly than we expected in our base case earlier in the year. In this evolving environment, we now see increased risk to corporate earnings and, more broadly, to the performance of particularly economically sensitive parts of the markets.

U.S. Economy and Markets: The U.S. economic cycle has advanced rapidly, from its early rebound and recovery to decelerating expansion, and could now be near an inflection point. The labor market is a key example: private payrolls largely recovered to pre-COVID levels in just 27 months, which is half the average recovery time after the prior three recessions, despite a much sharper and larger initial decline this cycle. However, that same early strength also leaves less room for continued improvement going forward. Similar rebounds in GDP and, importantly, corporate margins and profits also set up difficult comparisons going forward. Thus, while many economic data points remain sound, we see increased risks from the natural progression of the cycle.

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Slowing growth is normal and expected as the cycle advances, but, in addition to the rapid pace of the cycle thus far, we believe key factors unique to this cycle present additional risks. Fiscal stimulus helped fuel the early expansion, but we are now more than a year past the last round of distributions. Consumers still have abundant excess savings, but are shifting away from pandemic-related goods spending. Increased spending on services can help mitigate the impact of this trend, but overall spending growth still seems likely to slow as a result.

Inflation has reached 40-year highs as the cyclical rebound in demand outstripped supply, which remains hindered by ongoing supply chain disruptions and the impact of Russia's Ukraine invasion on global energy and food markets. By itself, inflation is a headwind to growth, as consumers can buy less for a given budget, and inflation typically raises financing costs for consumption and investment. In addition, we believe the Fed's recent shift toward increasingly aggressive monetary tightening to fight inflation exacerbates risks to growth this cycle.

Fed Exacerbates Risks

Overly aggressive Fed rate hikes could accelerate the natural cyclical slowdown.

However, the Fed does not act in a vacuum. In justifying its 75 basis point hike, the Fed reiterated the need to be "nimble" in adapting to incoming data. Inflation was already showing signs of a potential deceleration at the time of the Fed meeting. For example, autos have been a key driver of rising inflation over the past year, but new car prices have decelerated in recent months and, as of mid-June, the Manheim used car price index was down over 5% from its January high. If we see slowing growth and easing inflation, the Fed could slow or pause its tightening, leaving room for the economic cycle to extend beyond our 6-to-18 month investment horizon, but such an outcome is far from certain.

Recognizing the increased risks to earnings from Fed actions and the advancing cycle, particularly for more cyclical sectors, we have made various adjustments to U.S. equity exposure across our portfolios. We have reduced exposure to more economically sensitive U.S. sectors like Financials and Energy, and continued to emphasize sectors with more stable earnings outlooks in a slowing growth environment, such as Health Care, Information Technology, and Communication Services.

International: Looking abroad, the stability of developed market economies appeals to us as the global economic cycle continues to mature. As economic growth decelerates, earnings growth is likely to prove more resilient in developed markets than in emerging markets, in our view. This is evident in recent earnings estimate revisions. Over the past year, while 2022 consensus EPS estimates for international developed markets have been revised *up* by over 5%, EPS estimates for emerging markets have been revised *down* 14%.

In global portfolios, we are significantly underweight to emerging markets and, along with a U.S. overweight, are emphasizing developed Asia. Japan has seen only limited inflationary pressure, which is supporting more accommodative monetary policy. Further, we expect Japan's trade-driven economy will benefit from economic reopening in China, its largest trade partner, and the relative affordability of its goods following a sharp pullback in the yen since the start of 2021.

In contrast, we are underweight Europe. While Europe's developed economies should be less sensitive to slowing global growth than emerging markets, Europe faces significant inflationary pressures tied, in part, to its reliance on Russian energy. We believe elevated European earnings estimates underestimate risks particular to the region as fundamentals weaken.

Fixed Income: While risks to equities have increased, risks to fixed income have diminished, in our view, following the sharp rise in interest rates this year. Slowing economic growth and a likely easing of inflation should reduce upward pressure on intermediate and longer-term interest rates. Further, a Fed-induced slowdown could ultimately push longer-term interest rates down. Accordingly, in balanced strategies, we have added to fixed income and eliminated an overweight of equities. Within fixed income allocations, we have lengthened duration (increased interest rate sensitivity), reduced our overweight to corporate credit, and added to Treasury exposure.

Conclusion: The core of our investment approach is to align portfolios with the evolving economic environment. In Q2, we continued to advance our portfolio positioning for the mid- to late-cycle backdrop and increased risks to growth. As always, we will continue to actively position strategies based on our evolving outlook.

WestEnd Advisors Investment Team | July 5, 2022

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

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