Labor Market Strength is Key Support for Economy

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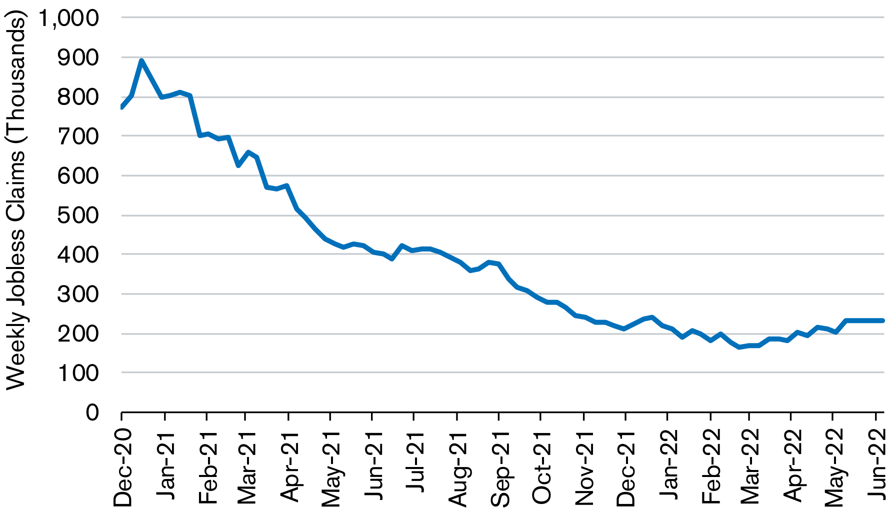
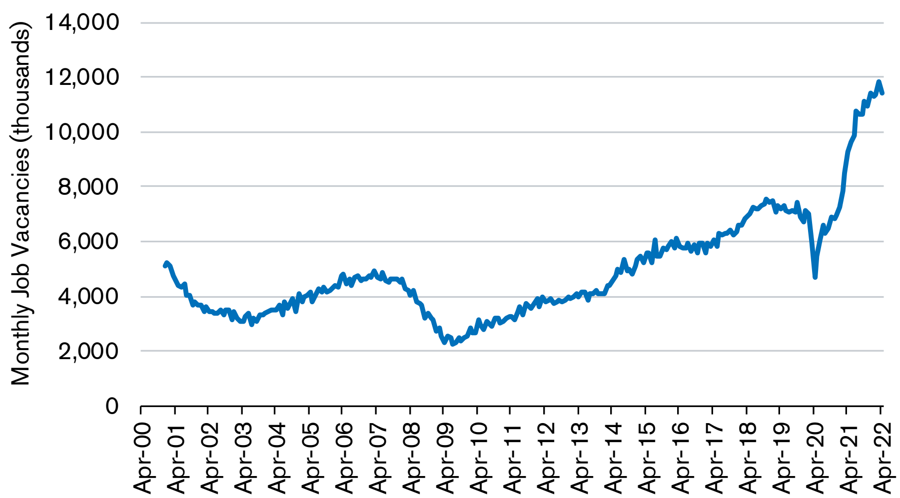
INITIAL JOBLESS CLAIMS



Source: DOL, WestEnd Advisors

U.S. JOB OPENINGS



Source: Department of Labor, WestEnd Advisors

Portfolio Impact: The labor market will be a key determinant of the path of U.S. economy. **While we expect corporate earnings growth to fall, the strong employment backdrop should support consumer-related sectors like Consumer Discretionary and Communication Services**. Still, we believe the evolution of the labor market in the coming months will significantly influence whether earnings actually decline and we avoid a recession, like in 2016.

While risks have increased across the economy, the labor market remains is good shape. Layoffs are low by historical standards and have only risen modestly from recent lows (top chart). Part of the reason layoffs are well below average is that businesses are facing a record number of open positions to fill (bottom chart).

Inflation has weighed on consumer sentiment readings, but consumers continue to spend. However, if consumers' sense of job security declines materially, we see that as a more serious threat to spending and the economy overall than the results of sentiment surveys.

Interest Rates Have Driven the Majority of the Market Selloff Year-to-Date

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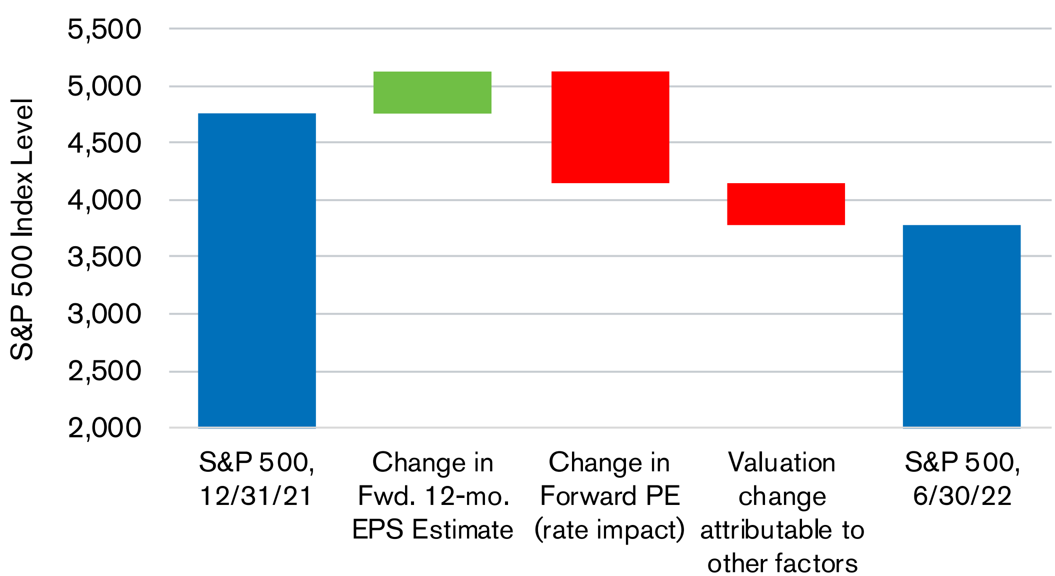
INTEREST-RATE VALUATION ADJUSTMENTS DRIVING YTD RETURNS



Source: WestEnd Advisors, Bloomberg

Portfolio Impact: The **risk of an earnings decline has increased** in our view, **most notably in cyclical sectors** which have seen large increases in earnings expectations due to fluctuations in commodity prices. We have **increased allocations to sectors** we see as **having less sensitivity to economic turbulence**, namely Health Care and Utilities.

We see much of the **year-to-date performance as driven by markets adjusting to higher interest rates**, as opposed to the market pricing in lower earnings. We can decompose market returns into 3 primary parts: change in earnings; change in forward multiples from interest rates; and change in forward multiples from other factors, such as uncertainty around earnings. **Consensus 12-month forward earnings have risen approximately +7.5% since the beginning of the year**. Year-to-date market performance has been all multiples-driven, and our work suggests the vast majority of the change has been driven by changes in interest rates.

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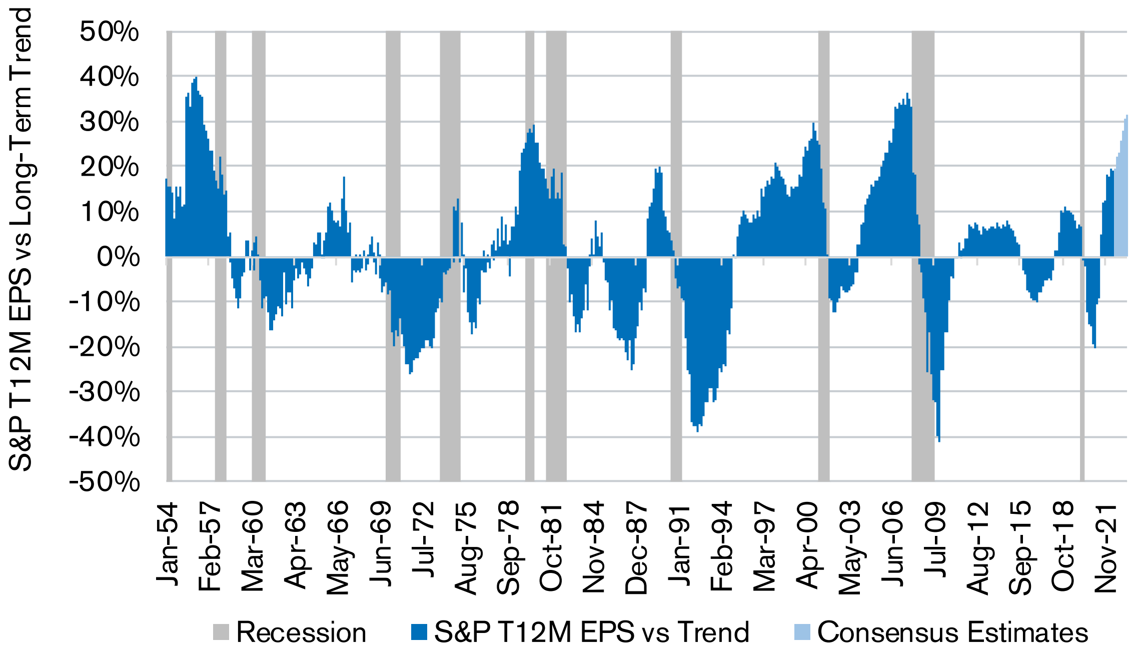
S&P 500 Earnings Upside is Limited From Here

S&P 500 EARNINGS WELL ABOVE LONG-TERM TREND



Source: WestEnd Advisors

Portfolio Impact: Earnings estimates appear increasingly optimistic against a backdrop of slowing economic growth. As such, we are avoiding the most cyclical parts of the market, such as Industrials and Financials, and have **increased exposure to sectors with more durable earnings power**, such as Health Care and Information Technology.

S&P 500 profits have rebounded swiftly since the depths of the pandemic. In June, trailing 12-month earnings were up over 60% compared to the trough in earnings that occurred in 2020. Consensus estimates are calling for another strong year of earnings growth in 2023 (~9% Y-O-Y). If achieved, **this would put S&P 500 EPS nearly 30% above its long-term trend, in-line with the high-end of the historical range**.

Against the backdrop of slowing economic growth and a rapidly maturing cycle, we see little potential for earnings growth upside to these forecasted levels, and if economic activity were to deteriorate faster than expected, earnings estimates could be at risk.

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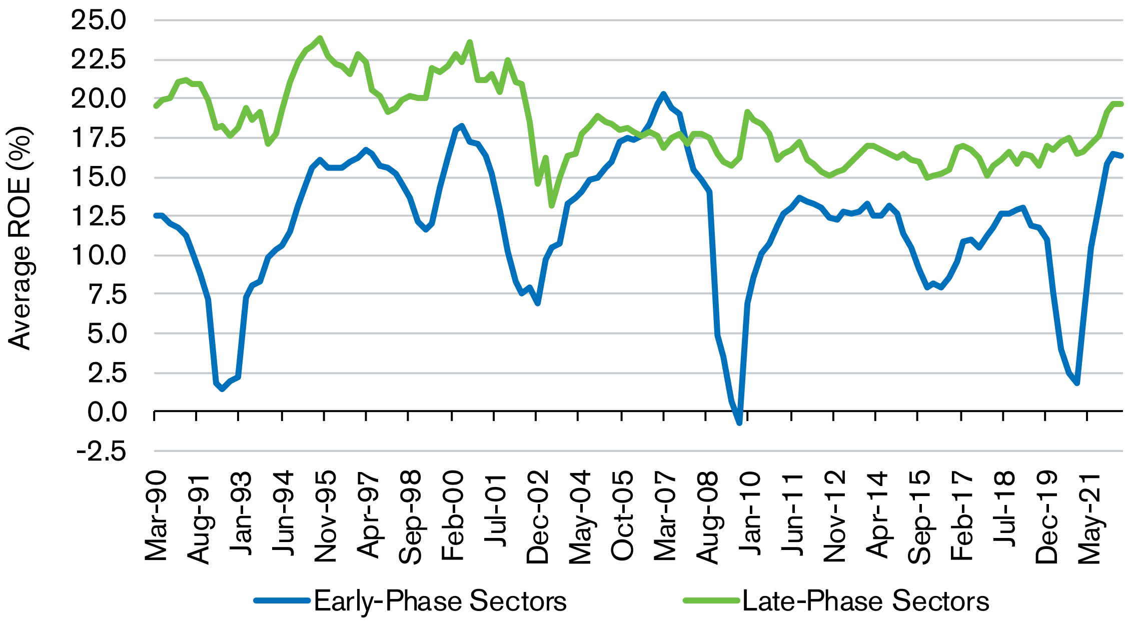
U.S. Sector Outlook

Late-Phase Sectors Provide Steady Earnings

RETURN ON COMMON EQUITY



Early-phase sectors include Energy, Materials, Industrials, and Financials.
Late-phase sectors include Health Care, Utilities, and Consumer Staples.

Source: WestEnd Advisors

Portfolio Impact: We believe exposure to defensive areas of the market – such as Health Care and Utilities – is warranted. **Consistent and above-market profitability** makes these sectors more attractive than economically-sensitive sectors at this stage of the cycle, in our view.

We see the financial stability of Health Care and Utilities as desirable, particularly as the economic cycle matures and the risk of a slowdown in economic growth increases.

Defensive, late-phase sectors have consistently generated above-market return on equity (ROE) over time. More importantly, **their ROEs are very consistent**. Alternatively, economically-sensitive sectors like Energy, Materials, Industrials, and Financials have much more cyclical ROEs, as illustrated in the chart above.

Health Care Sector Delivers Steady Earnings Growth

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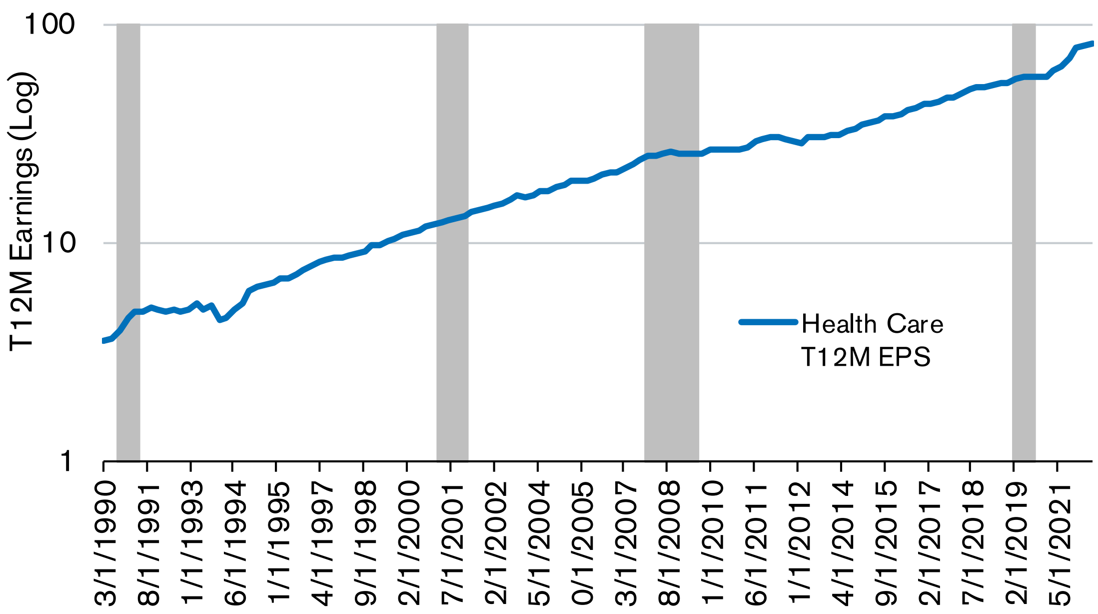
STEADY HEALTH CARE EARNINGS, EVEN IN RECESSIONS



Shaded = recession. Source: WestEnd Advisors, Bloomberg

Portfolio Impact: We believe **Health Care sector** exposure **provides attractive defensive characteristics** with insulation from cyclical risks, but is also **well positioned if the cycle extends.**

The **Health Care sector's lack of cyclicality and strong earnings offer an attractive combination**, in our view, as the pace of economic growth slows in the U.S. The sector is positioned well for the remainder of 2022 and into 2023 as **more elective procedures and higher volumes** overall benefit both health care providers and medical device makers. We also see a **healthy investment cycle** as further tailwinds to the sector coming **from pharmaceutical and biotechnology companies**, which put projects on hold to focus on the Covid-19 response,.

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Communication Services Sector Offers Compelling Combo of Growth and Valuation

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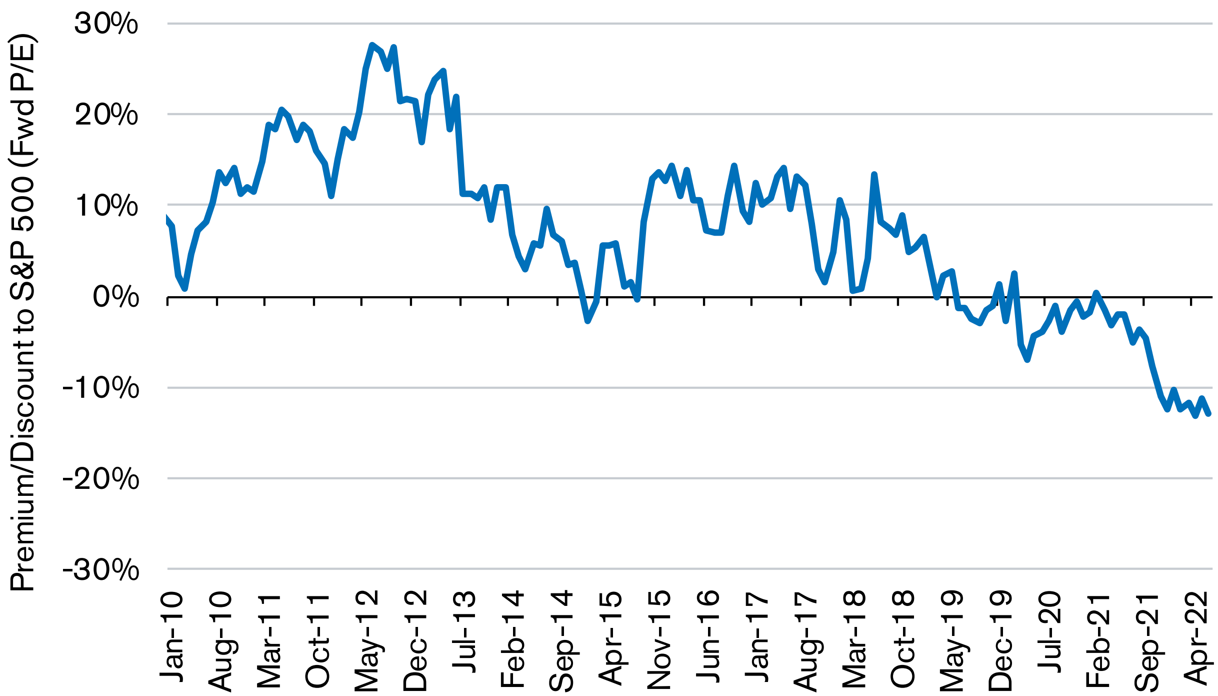
COMMUNICATION SERVICES P/E DISCOUNT TO S&P 500



Source: Bloomberg, WestEnd Advisors

Portfolio Impact: As the economy moves forward, we expect investors are likely to **reward sectors with attractive combinations of growth and valuation**. We see the **Communication Services** as a strong example of a sector meeting those criteria.

We see a **positive earnings picture** for the **Communication Services sector** in the period ahead. We expect Communication Services EPS could surprise to the upside, driven by a shift to services spending. We believe these **positive earnings developments, together with attractive valuations, create the opportunity for the Communication Services sector to outperform** in our 6-to-18 month investment window.

Tech Sector is Well Positioned For the Next Stage of the Cycle

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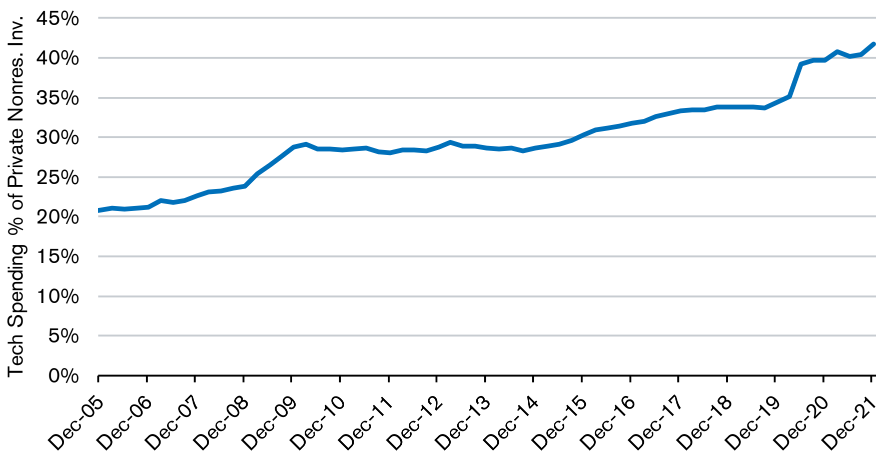
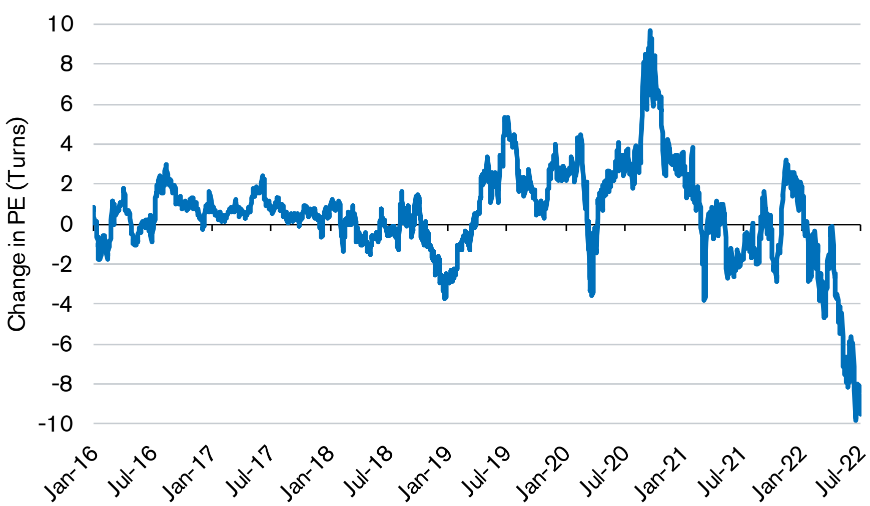
INFO PROCESSING EQPT + SOFTWARE AS % OF PRIV. NONRES INVESTMENT



Source: BEA, WestEnd Advisors

TECH SECTOR FWD P/E (6M ROLLING CHANGE)



Source: Bloomberg WestEnd Advisors

Portfolio Impact: As economic growth continues to slow, **we believe Information Technology will see less revenue and earnings growth deceleration than other economically-sensitive areas of the market** due to strong secular growth trends benefitting the sector. As a result, we used the market volatility in Q2 to continue to **increase our allocation to Information Technology** at an attractive valuation.

Businesses and consumers have increasingly embraced digital platforms in recent years. Due to the growing adoption of these services, **business investment spending on information processing equipment and software rose to an all-time high last year, a trend which we expect to continue as businesses look for ways to increase efficiency and margins in a slower growth environment.**

While the Information Technology sector commands a valuation premium due to its strong growth drivers and margins, we would note that Information Technology valuations recently recorded a sharp pull back, the most for any 6-month month window in the last six-plus years (see bottom chart).

Utilities Valuation In-Line with History

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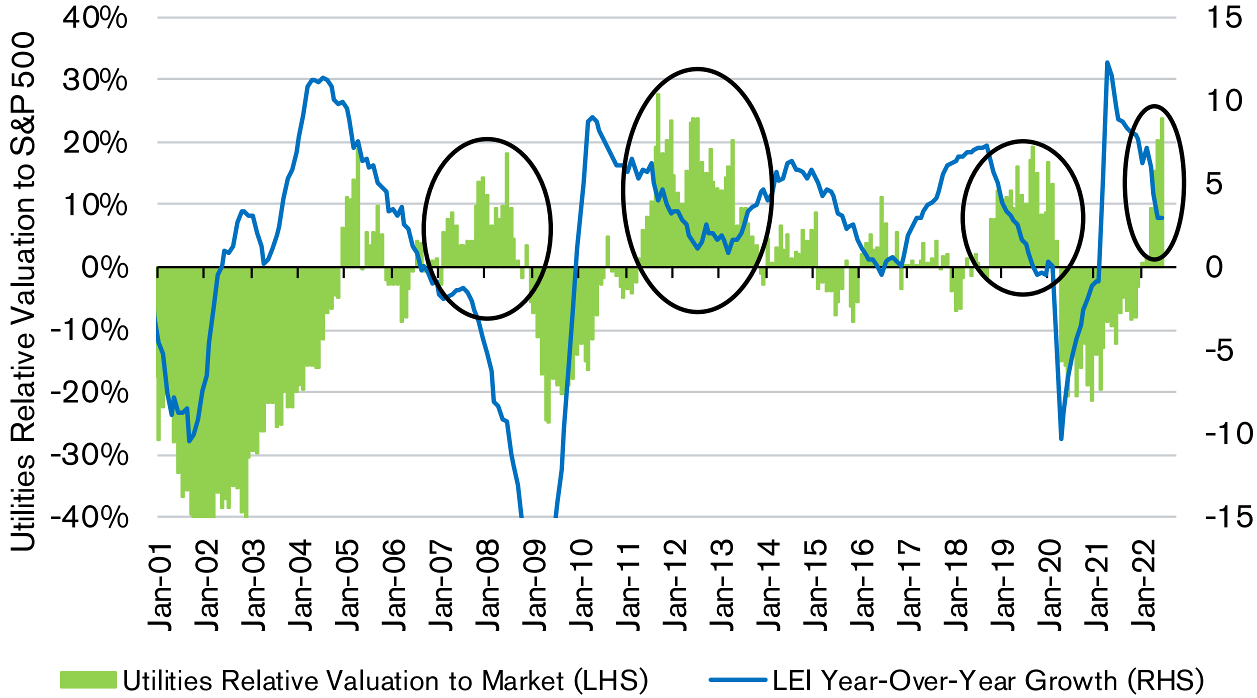
UTILITIES COMMANDS A PREMIUM DURING SLOWDOWNS



Source: WestEnd Advisors

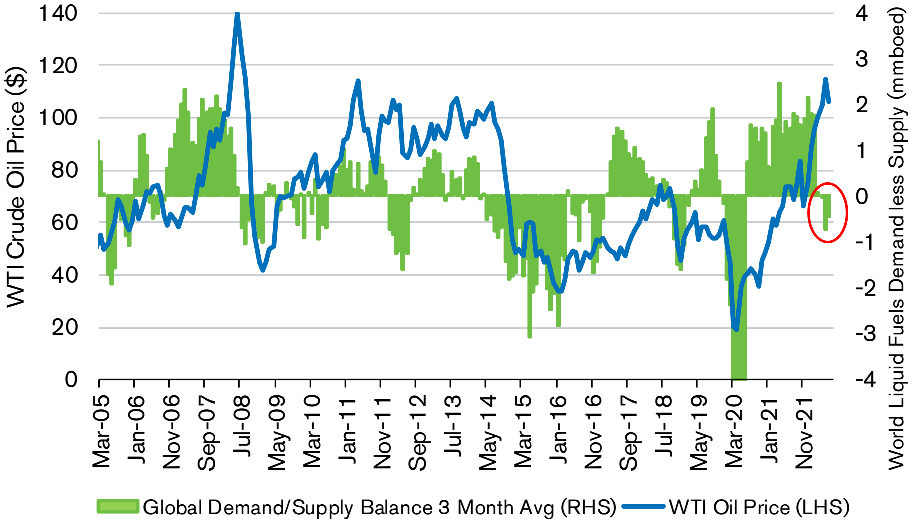
Portfolio Impact: As the economy matures and growth downshifts to a lower gear, we expect investors to continue to **pay a premium for late-phase sectors that can generate positive earnings growth in a recessionary environment, such as Utilities**. Earnings downgrades in the more cyclical parts of the market would make those sectors more expensive than they currently appear.

The relative valuation of the Utilities sector has become expensive this year during the recent bout of elevated market volatility. While this would make the sector less attractive in a dynamic growth environment, we believe the stability of the sector's revenues and earnings leaves Utilities well insulated from the mounting economic risks that are rising in the more cyclical parts of the market.

As shown in the chart above, **the relative valuation of the Utilities sector tends rise during periods of slowing economic growth**, and the current ~20% valuation premium is not out of line with history.

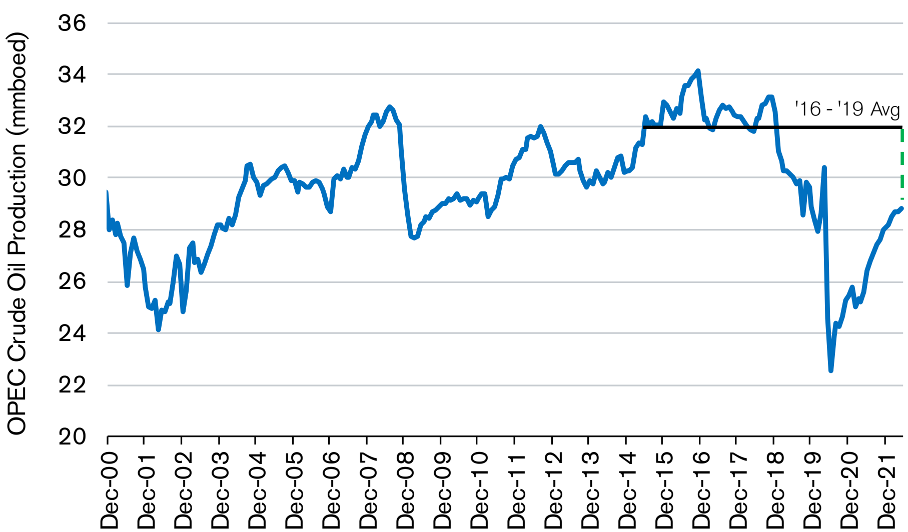
Expect Energy Markets to Become More Balanced

ENERGY MARKETS ARE BECOMING MORE BALANCED



Source: EIA, WestEnd Advisors

OPEC'S ABILITY TO PRODUCE IS UNDERAPPRECIATED



Source: Bloomberg, WestEnd Advisors

Portfolio Impact: Energy exposure is appropriate, in our view, given cheap valuations and the inflationary nature of this cycle. However, the **risk/reward profile for the sector has become more balanced**, and we maintain a **modest underweight of the U.S. Energy sector** in our ETF strategies.

The rapid nature of the global economic recovery and undersupplied energy markets have driven oil prices up significantly over the past two years.

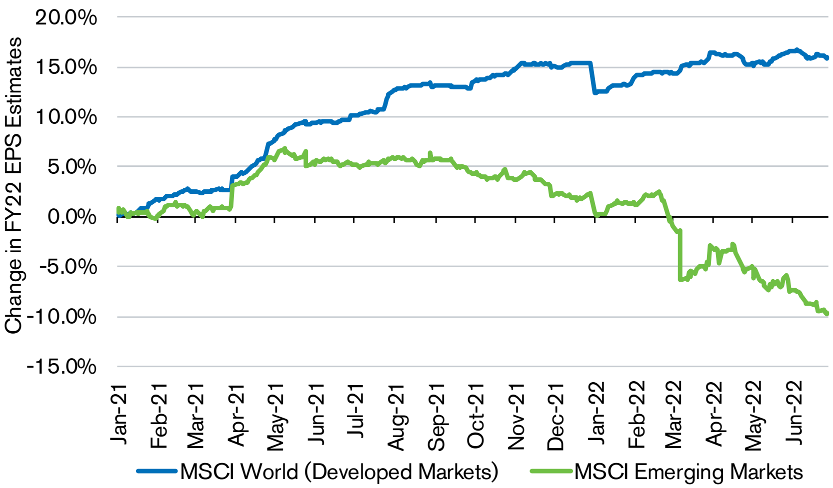
Looking ahead, **we do not view the recent state of the energy market as sustainable**. Oil & gas demand growth has started to decelerate as the global economic cycle matures, which has led to a more balanced supply-demand backdrop in recent months (see chart above).

Furthermore, with oil producers making more profit per barrel than ever before, we believe there is a growing risk that incoming supply surprises to the upside. **North America, OPEC (see bottom chart), and parts of Latin America all have the potential to raise production from current levels.**

International Economic & Market Backdrop

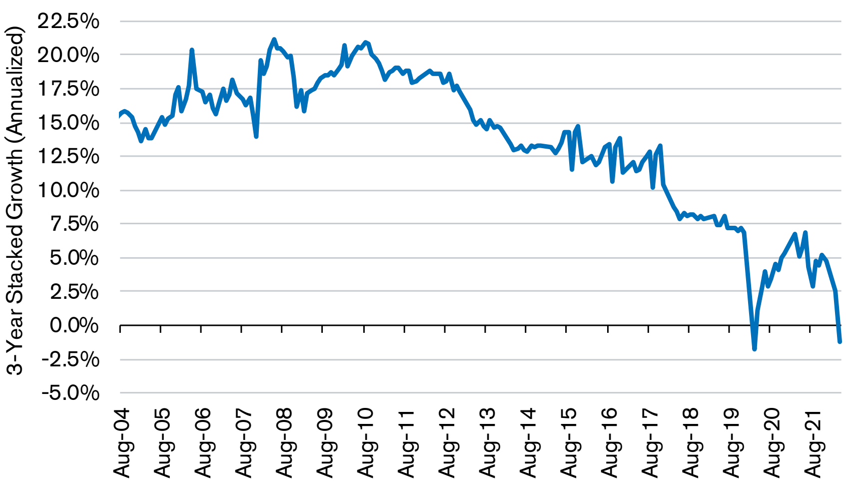
Maturing Cycle Warrants Greater Allocation to Developed Markets

2022 EARNINGS ESTIMATE REVISIONS



Source: Bloomberg, WestEnd Advisors

CHINA RETAIL SALES % GROWTH (3-YEAR STACK)



Source: NBSC, WestEnd Advisors

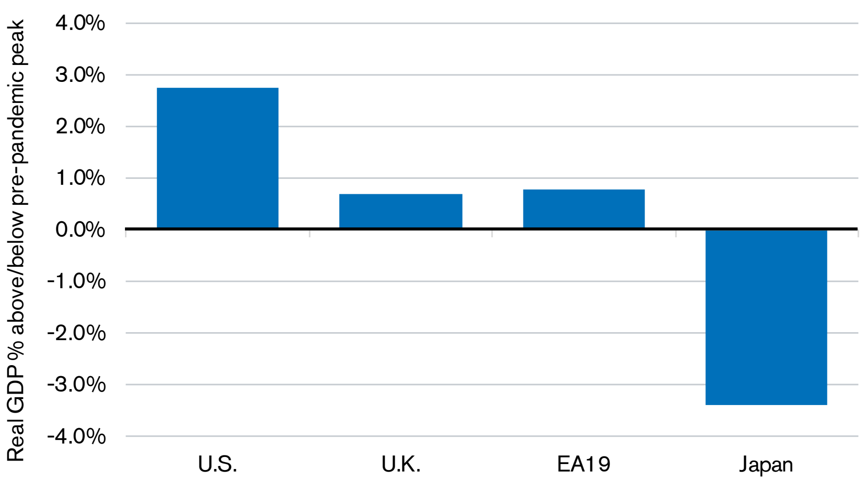
Portfolio Impact: In our view, international developed economies are likely to generate stronger sales and earnings growth relative to emerging markets as the economic cycle continues to age. As such, we remain **overweight the U.S. and have a significant underweight to emerging markets.**

The stability of developed market economies appeals to us as the global economic cycle continues to mature. **During periods of economic deceleration, earnings growth in developed market countries is likely to prove more resilient than in emerging markets, in our view.** This has been reflected in diverging fiscal 2022 EPS estimate revisions over the last year (see chart above).

In China, which accounts for over 25% of emerging markets, the economic cycle is further along compared to developed markets. Growth is now decelerating as export demand peaks, the property sector slows, and household consumption stagnates. Furthermore, **the ongoing threat of COVID-19 restrictions, coupled with job layoffs and declining real estate values, has impeded consumer spending and broader economic activity.** We believe this presents additional downside risks to Chinese earnings estimates in 2022 and beyond.

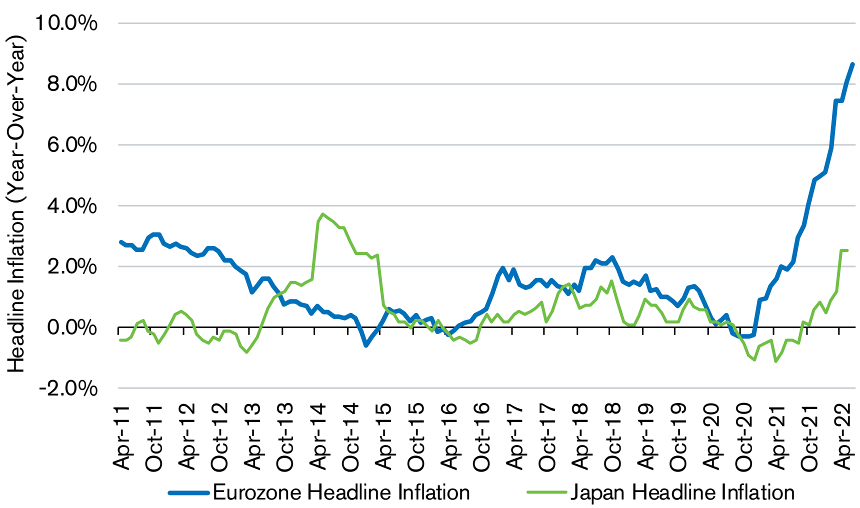
Japan's Economic Recovery Remains Intact
Europe Faces New Risks

REAL GDP REMAINS DEPRESSED IN JAPAN



Source: WestEnd Advisors, BEA, Eurostat, ESRI Japan, UK ONS

EUROZONE FACING SIGNIFICANT INFLATION HEADWINDS



Source: Eurostat, MIAC, WestEnd Advisors

Portfolio Impact: An **overweight allocation to Japan is warranted**, in our view, given its **prospects for an economic rebound in 2022** as well as a **historically-cheap valuation**. We have **reduced our position in Europe**, given the region's near-term growth headwinds and heightened geopolitical uncertainty.

While Europe and Japan have experienced slower recoveries than the U.S., **we believe Japan could benefit from an economic rebound in the second half of 2022, given that real economic activity remains depressed versus pre-pandemic levels (see top chart).**

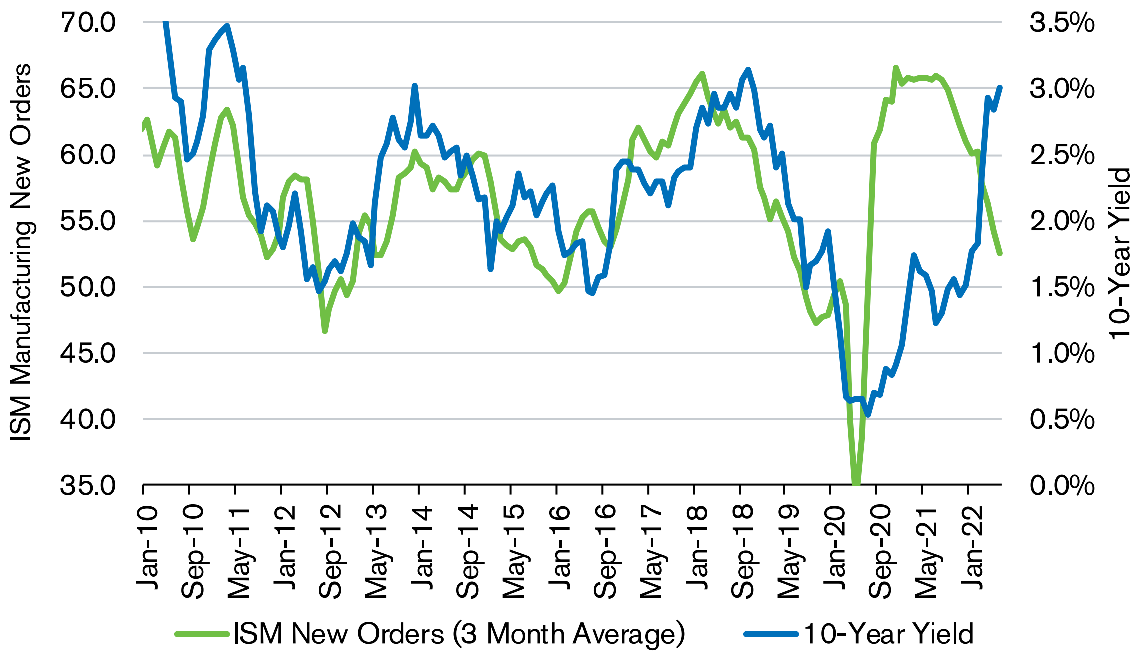
Personal consumption growth is an area of potential upside for Japan, which **saw a more significant savings build-up as a percent of GDP compared to the U.S. and Europe.** This, along with a healthy labor market, could provide fuel to Japan's spending upswing.

We believe Europe is likely to face more material near-term economic headwinds stemming from the recent surge in energy prices. As shown in the bottom chart, **headline inflation in Europe has climbed significantly relative to headline inflation in Japan, which could weigh on *real* consumer spending** as European consumers are forced to spend more on gas and utilities.

Interest Rates & Inflation

Peak in Interest Rates May Be Approaching

SOFTENING REAL ACTIVITY REDUCES UPWARD PRESSURE ON RATES



Source: Institute for Supply Management, WestEnd Advisors

Portfolio Impact: Given the worst performance to start the year for U.S. bonds in over four decades and a growing likelihood that the peak in long-term interest rates could be approaching, we believe **risks to fixed income market returns have diminished**. At the same time, slowing economic growth and earnings headwinds could pose further risks to equity markets. As such, we have **reduced the equity overweight in our balanced portfolios and added to fixed income allocations**.

Interest rates have surged higher this year amid acute inflationary pressures and a rapid pull-forward in the Federal Reserve's tightening timeline. As a result, **bonds have had the worst performance to start the year in over four decades.** Looking ahead, we believe the upward pressure on interest rates is likely to diminish as economic growth slows and inflation pressures begin to moderate.

As shown in the chart above, **interest rates tend to move lower during periods when leading economic indicators, such as the ISM Manufacturing New Orders Index, signal declines in real economic activity**.

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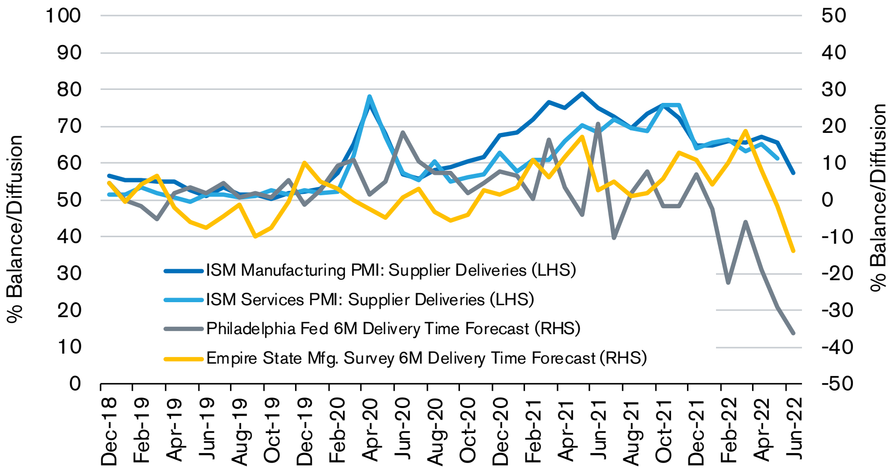
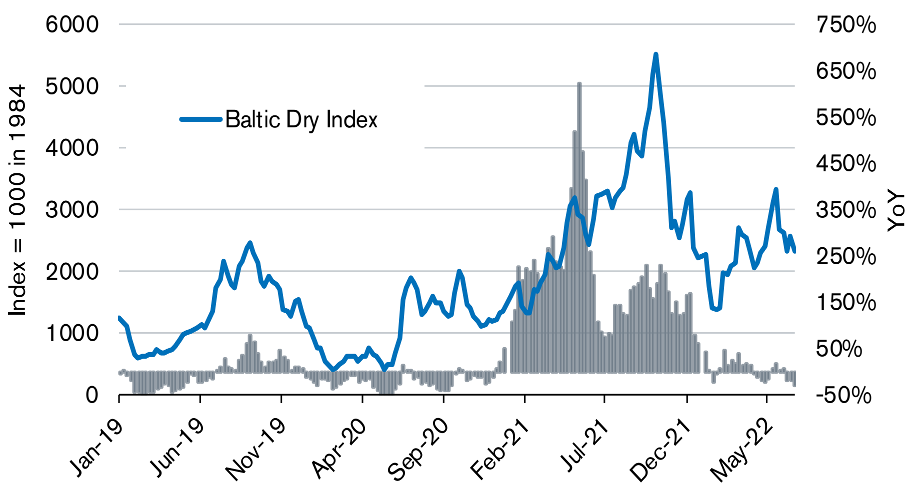
Supply Chain Pressures Finally Starting to Reverse

DELIVERY TIMES ARE CORRECTING,
FED SURVEYS POINT TO FURTHER IMPROVEMENT



Source: Institute for Suppy Chain Management, Federal Reserve, WestEnd Advisors

SHIPPING COSTS HAVE BEGUN TO NORMALIZE



Source: Bloomberg, WestEnd Advisors

Portfolio Impact: Mid-phase sectors, including **Information Technology and Consumer Discretionary, should benefit from improving supply chains enabling constituents to meet customer demand.** Semiconductor manufacturers have been unable to meet customer demand, and should see improving revenues as they are able to work through their order backlogs. Consumer Discretionary companies have similarly struggled to meet excess demand and, should consumers' propensity to spend remain elevated, companies in the sector stand to benefit.

U.S. inflation has stemmed from strong demand from consumers, whose balance sheets were buoyed by direct stimulus payments, coupled with supply chain issues stemming from Covid-19 restrictions both domestically and internationally. We are beginning to see signs of supply chains improving. Moderating shipping costs and improving delivery times should benefit the U.S. economy broadly and improve the current supply/demand mismatch.

Corporate Financial Strength Makes Credit Attractive

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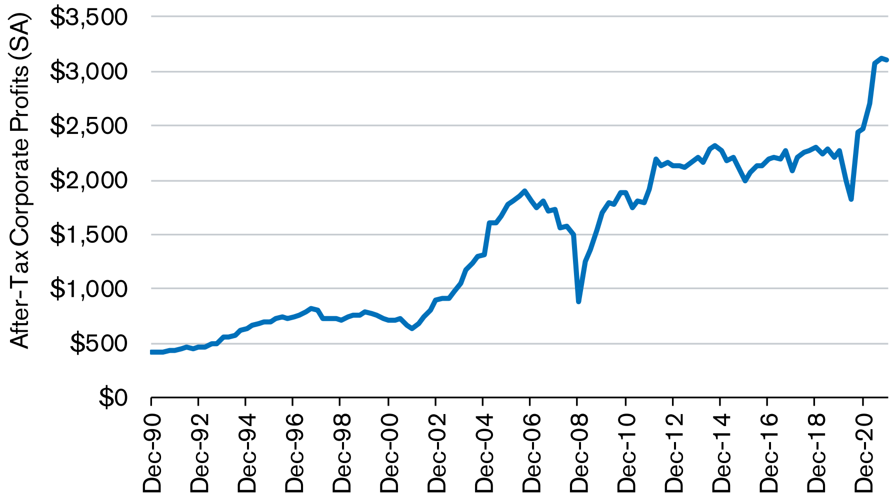
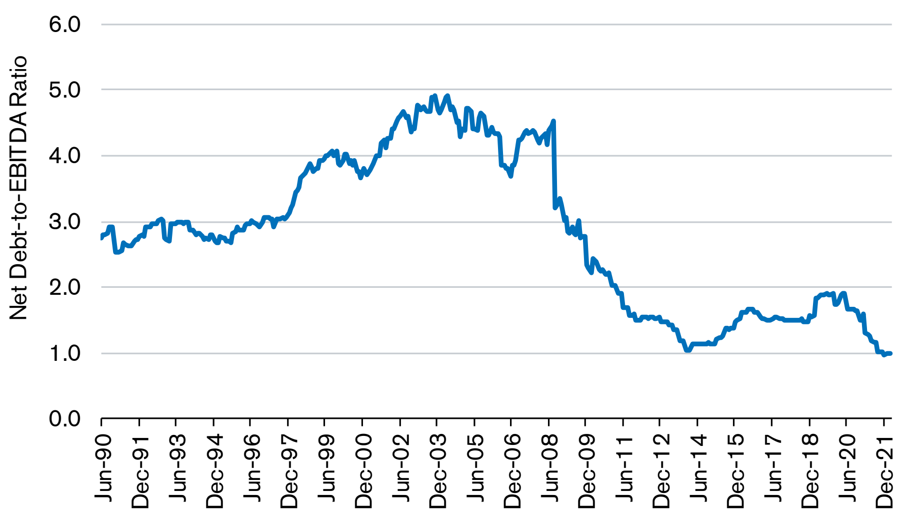
CORPORATE PROFITS



Source: BEA, WestEnd Advisors

S&P 500 NET DEBT-TO-EBITDA NEAR HISTORIC LOWS



Source: Bloomberg, WestEnd Advisors

Portfolio Impact: Economic fundamentals in the U.S. remain sound, in our view, and **corporate profitability and balance sheets are healthy**. In this environment, we continue to favor corporate credit relative to Treasury bonds in fixed income allocations.

U.S. companies are experiencing record profits, as seen in the top chart, driven by both strong revenue growth and margin expansion.

These corporate financial gains have supported corporate balance sheets. The strong profitability, together with low overall interest rates, allowed many companies to lower their debt service burdens while extending the maturities on their debt.

Strong cash flow gains and balance sheet management have resulted in the **lowest leverage profile for the S&P 500 in at least three decades** (bottom chart).

Longer Inflation Expectations Well-Anchored

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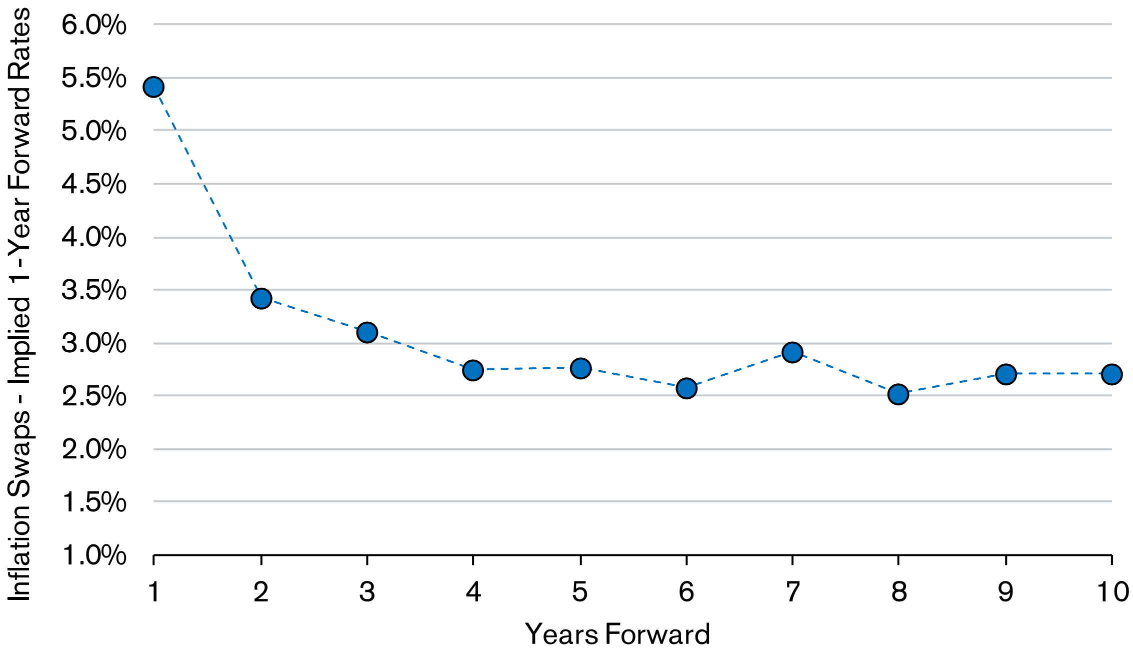
FORWARD INFLATION EXPECTATIONS CURVE



Source: Bloomberg, WestEnd Advisors

Portfolio Impact: Given our view that **longer-term inflation expectations remain well anchored** and, thus, are unlikely to put significant further upward pressure on long-term interest rates, we are comfortable maintaining **modestly higher duration compared to the benchmark in our fixed income allocations.**

Inflation has become a key area of concern for both investors and the Federal Reserve. In our view, core inflation is likely to moderate in the second half '22 as many transitory pandemic effects and supply chain shortages fade. **As shown in the chart above, inflation expectations remain well-anchored over intermediate-and-long term time horizons**. While this may limit the risk of an upward inflationary spiral, we still expect the PCE price index to remain above the Fed's 2% target, putting upward pressure on interest rates and giving the Federal Reserve an all-clear to continue to normalize policy. In contrast, **short-term inflation breakevens have risen to the highest levels in decades, which limits the appeal of TIPS compared to equities and corporate credit, in our view.**

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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 47 country indexes comprising 23 developed and 24 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.

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