WESTEND
Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

Q3 2022

Navigating Late-Cycle Conditions

While some economic data remains sound, deterioration in other data suggests a maturing economic cycle. We believe the Fed's monetary stance has increased the risk of recession, and we see potential for disappointing earnings, particularly for more economically sensitive parts of the market.

SUMMARY

- We perceive late-phase economic conditions with increased risk of recession in the U.S. tied to aggressive Fed actions.
- We see greater headwinds to equity returns abroad, with Europe and emerging markets facing particularly elevated risks.
- Upward risk to long-term interest rates has diminished, in our view, as economic growth and inflation slow and the Fed tightens.

Q3 2022 REVIEW

Markets remained very volatile in Q3 2022 as the economic backdrop continued to evolve and the Federal Reserve escalated its aggressive monetary tightening. A variety of key economic measures remained sound in Q3, including hiring and retail sales growth. Deterioration continued, however, in other economic data, including the Leading Economic Index (LEI), which is now down on both a 6-month and year-over-year basis, and the yield curve, which continued to invert as some short-term interest rate increases outpaced a rise in long-term rates.

Stock markets around the world began the quarter by continuing a rally off of lows in June, following the Fed's first 75 basis point rate hike. However, market gains reversed in the second half of the quarter, after FOMC meeting minutes and Fed member speeches stoked fears the Fed could tighten too much and push the economy into recession. The pullback accelerated in September as the August CPI reading came in higher than expected and Fed Chair Powell repeatedly reiterated the Fed's resolve to manage inflation despite the potential for economic pain. The S&P 500 returned -4.9% in Q3, down more than 16% from its mid-quarter peak.

Interest rates were a key U.S. market driver in Q3, in our view. As the Fed raised its target Fed Funds rate another 1.5 percentage points in Q3, the 10-year Treasury yield rose more than a percentage point off its August 1 low and brushed up against 4% for the first time in over a decade. Year-to-date, the 10-year Treasury yield is up about 2.3 percentage points. Rising rates have driven negative fixed income returns and weighed on equity valuations throughout the year. Our analysis indicates that the impact of rising rates accounts for essentially all of this year's equity market declines.

Unusual Correlation

Negative stock and bond returns in the same year are rare, but have typically been followed by above-average bond returns the next year.

Equity sector performance in the U.S. was mixed and volatile in Q3. Consumer Discretionary was the best-performing sector in Q3, followed by more economically sensitive sectors like Energy, Financials, and Industrials. In the last month of the quarter, however, the traditionally more defensive Health Care and Consumer Staples sectors outperformed, while Energy and Industrials were more market-like. Real Estate lagged in Q3, likely tied to its interest rate and economic sensitivity, while Communication Services was the worst performing sector.

Internationally, major equity markets were mixed versus the U.S. in local currency, but generally underperformed in U.S. dollar-terms as the dollar rallied against major currencies in Q3. Europe's fundamental challenges tied to the war in Ukraine showed up in economic data in Q3 after activity initially held up surprisingly well in the wake of the war, while China faced disruptions from its zero-COVID lockdowns. Japan was a relative bright spot, as it started lifting the last of its COVID restrictions and its central bank began stepping in to defend the yen.

OUTLOOK

The current global economic cycle has evolved rapidly, and recent deterioration in various economic data suggests a shift to later-cycle economic conditions. Some areas of the global economy remain sound, like the labor market and consumption in the U.S., but we now see slower economic growth ahead, with increased risk of recession partly tied to the Fed's aggressive rate hikes. Slower growth, in turn, creates greater potential for disappointing earnings growth, particularly for companies in more economically sensitive sectors and regions.

U.S. Economy and Equities: We still see strength in U.S. consumer spending, supported by a tight labor market, and in business

investment. Negative GDP readings in Q1 and Q2 reflected volatile factors like international trade and inventory swings more than underlying fundamental weakness, in our view, and Q3 GDP was likely positive. Recent declines in the LEI, inversion of the yield curve, and aggressive Fed tightening, however, suggest slower growth ahead.

Historically, Fed rate hikes typically have had a lagged impact on economic activity. Some areas, like housing, already appear to be responding to tightening, but we believe the full economic effects of the 300 basis points of rate hikes already implemented have yet to be felt, and the Fed has signaled additional hikes are all but certain with its commitment to quell inflation.

Fed's Impact to Come
We believe the economic impact of aggressive Fed policy has yet to be felt.

A primary driver of inflation in 2021 and the first half of 2022 was the surge in the price of durable goods, and particularly automobiles, tied to extraordinary demand and constrained supply chains. More recently, we have seen easing demand for durable goods, even as supply chains appear to be healing. The price of oil also contributed significantly to headline inflation this year, as WTI crude rose more than 20% early in the year to about $92 a barrel and spiked over $120 after Russia invaded Ukraine. Oil trended back toward $80 in Q3, however, to roughly where it was this time last year. Rising costs in areas like health care and housing have also contributed to core inflation, but we believe the recent trends in goods and energy should help ease inflation going into 2023. That could allow the Fed to slow or pause its monetary tightening in time to extend late-cycle growth. We see no sign of a pause yet, but reduced fear over rising interest rates could boost valuations of growth-oriented sectors like Information Technology and Communication Services.

Regardless of whether late-cycle economic growth persists over the next 6 to 18 months or proves shorter lived, we see little chance of a return to dynamic economic growth this cycle, given the economic progress to date and the extended impacts of monetary tightening. Accordingly, we are avoiding early-phase cyclical U.S. sectors in all our strategies. We instead are emphasizing sectors that we expect will see less deceleration in earnings as growth slows. In particular, we have added to our late-phase, defensive U.S. sector exposure, which now includes overweights of Health Care, Consumer Staples, and Utilities.

International: In global portfolios, we remain underweight to international equities, as a whole. This includes underweights of Europe, which faces headwinds from the war in Ukraine, and of emerging markets, partly due to their economic sensitivity, but we maintain an overweight of developed Asia.

We see risks mounting rapidly for European households and businesses tied to fallout from the war in Ukraine. Natural gas prices are now nearly seven times higher in Europe than in the U.S. That, along with potential gas shortages this winter, could weigh heavily on European manufacturing activity and has pushed consumer sentiment to a record low that could weigh on spending moving forward.

Emerging markets (EM) tend to be very economically sensitive and are likely to underperform, in our view, as the global economy slows. For EM Asia, in particular, we view less accommodative monetary and credit conditions, peaking global demand growth for goods, and China's zero-COVID policies as additional near-term headwinds.

Developed Asia is where we see the greatest potential for economic resilience abroad. In Japan, the government has recently announced plans to lift most COVID-related restrictions on tourism and travel. Yen weakness has weighed on Japanese equity returns for dollar-based investors this year, but the Bank of Japan recently began supporting the yen, which we believe is significantly undervalued and, in turn, could support growth Japan's export-driven economy.

Fixed Income: Inflation, monetary policy tightening, and rising real yields have all contributed to the sharp rise in rates across the yield curve this year. We believe that the risk of a significant additional increase in *long-term* interest rates has been reduced, and that continued short-term rate hikes, along with slowing economic growth and easing inflation pressures are more likely to drive further inversion of the yield curve rather than higher long-term yields. Seeing reduced risk to fixed income returns and increased late-cycle economic risks to equity returns, we have shifted to a modest overweight of fixed income in balanced portfolios. Within fixed income allocations, we have also reduced our overweight of corporate debt and added floating rate Treasury exposure.

WestEnd Advisors Investment Team | October 3, 2022

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20221003-2456509