WESTEND Advisors

A VICTORY CAPITAL® INVESTMENT FRANCHISE

# Macroeconomic Highlights

## Q4 2022

20221003-2456754

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# WestEnd Outlook Highlights

- With the rapid evolution of this economic cycle, deterioration in some data along with the Fed's aggressive monetary policy stance point to later-cycle economic conditions in the U.S., where we see slower economic growth, increasing risk of recession, and higher potential for disappointing earnings growth, particularly for companies in economically sensitive parts of the market.
  - A key variable, in our view, is the Federal Reserve's accelerated path of monetary policy tightening, with the sharpest course of rate hikes in at least half a century, which we believe has increased the risk of recession.
  - Some areas of the global economy remain sound, such as the U.S. labor market and consumption, but we see little chance of a resumption of rapid, dynamic economic growth, given the progress of the cycle to date and ongoing Fed hikes.
  - Upward risk to long-term U.S. interest rates has diminished, in our view, as growth and inflation slow and the Fed tightens.
- Internationally, as global economic growth slows, we see risks mounting for Europe tied to the war in Ukraine, and we expect headwinds for economically cyclical emerging markets, while developed Asia is a relative bright spot.
- We have continued to adjust portfolios for ongoing progression of the economic cycle and in view of new risks:
  - In U.S. large-cap equity allocations:
    - 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 economic growth slows.
    - We have added to our late-phase, defensive sector exposure, with overweights of Health Care, Consumer Staples, and Utilities.
  - In global portfolios, we remain underweight to international equities, as a whole, including underweights of Europe and emerging markets, but we maintain an overweight of developed Asia, where we see the greatest potential for economic resilience abroad.
  - In balanced portfolios:
    - Seeing reduced risk to fixed income returns, and late economic cycle risks to equities, 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.

# U.S. Equity Sector Allocations

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## WESTEND ETF STRATEGIES

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

**Sector Allocations**

- Health Care
- Communication Services
- Information Technology
- Utilities
- Consumer Staples
- Consumer Discretionary

**Sector Avoidance**

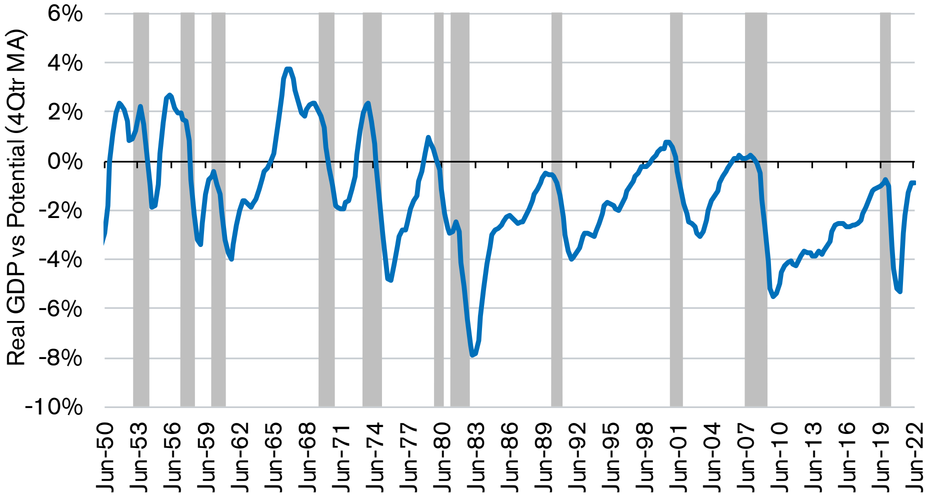
- Energy
- Financials
- Industrials
- Materials
- Real Estate

* For illustrative purposes only. Allocation information as of September 30, 2022. Source: WestEnd Advisors.

# U.S. Economic & Market Backdrop

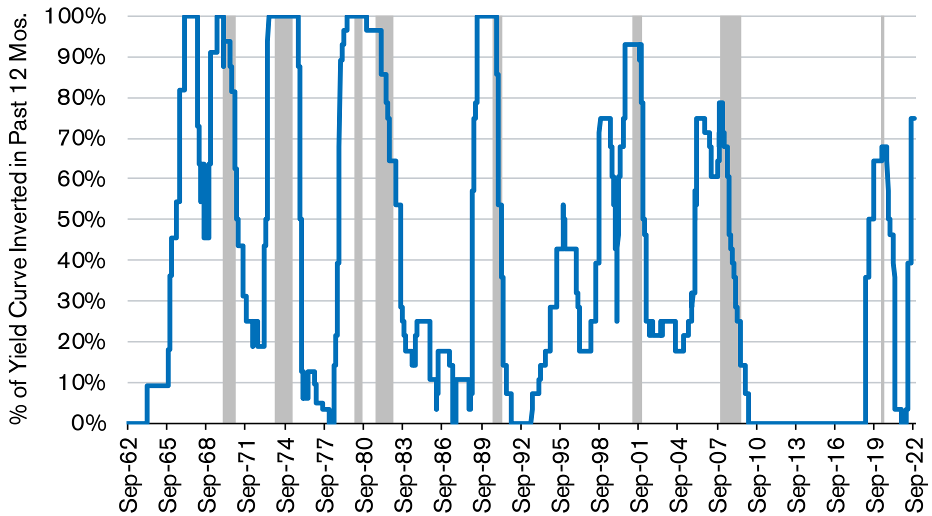
# Fast Moving U.S. Economic Cycle Exhibits Late Cycle Characteristics

### U.S. GDP STILL BELOW POTENTIAL




Source: BEA, CBO, WestEnd Advisors

### CURVE INVERSION DIFFUSION INDEX




Source: WestEnd Advisors

**Portfolio Impact:** The U.S. economy continues to exhibit more late-cycle characteristics, which warrants an emphasis of defensive sectors like **Health Care, Utilities, and Consumer Staples**, in our view, as well as avoidance of highly cyclical sectors like **Energy, Industrials, and Financials**.

The U.S. economy likely delivered positive GDP growth in Q3, yet the economy remains below the CBO's estimate of economic potential and below levels typically achieved prior to recessions (top chart). These factors, along with a **strong labor market and growth in consumer spending,** could support an **extension of the cycle.**

At the same time, a number of U.S. economic and market developments, including further inversion of the yield curve (bottom), **point to the maturing of the U.S. cycle**. Deterioration in some data, along with the Fed's monetary policy stance, point to later-cycle economic conditions. We believe this evolution likely indicates slower economic growth, increased risk of recession, and **higher potential for disappointing earnings growth**, particularly for companies in economically sensitive sectors of the economy.

# Pace of U.S. Growth is Moderating as the Cycle Advances

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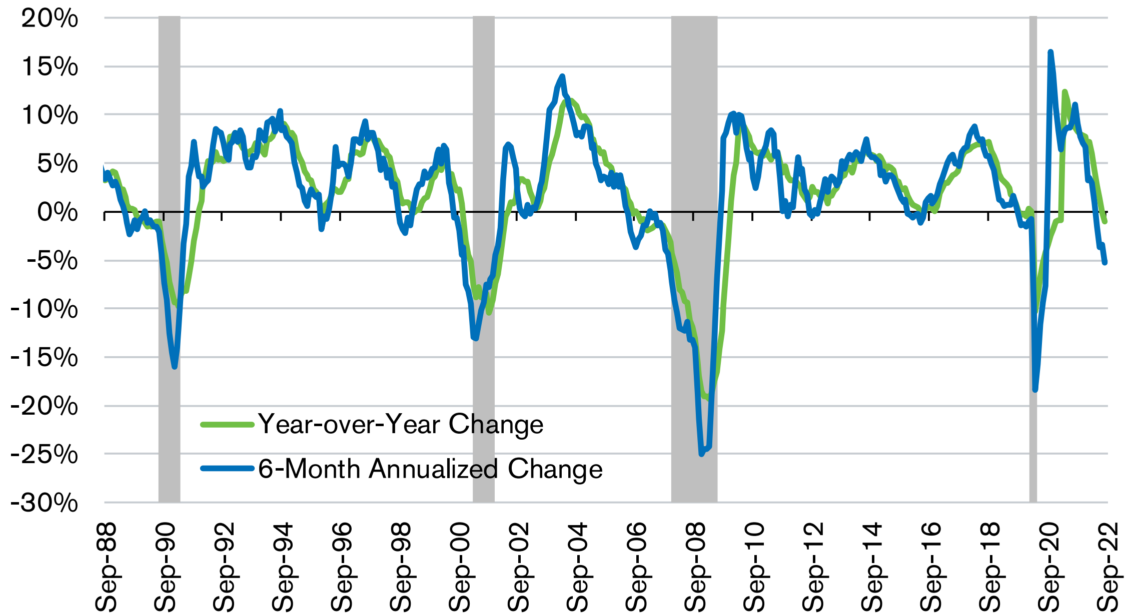
### LEADING ECONOMIC INDEX




Source: Conference Board, WestEnd Advisors

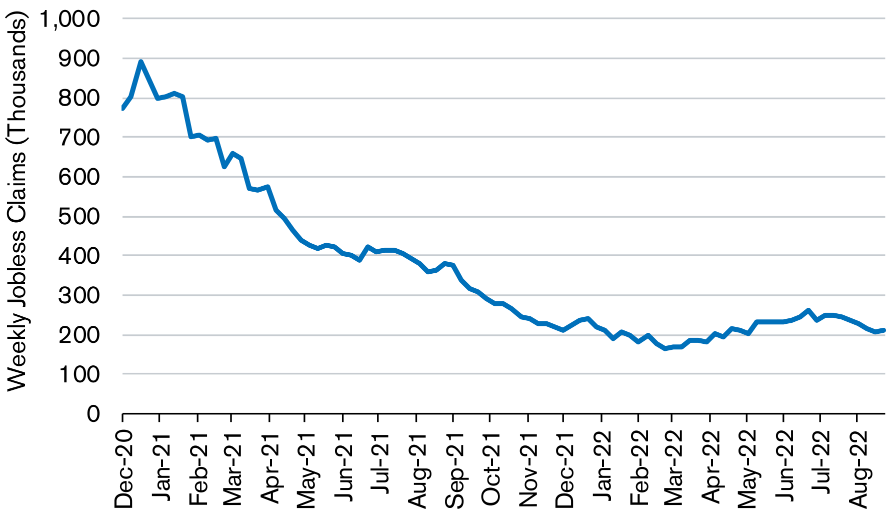
**Portfolio Impact:** The **deceleration in U.S. growth we anticipated** at the start of 2022 is playing out. We have transitioned portfolios to an **avoidance** of highly economically sensitive U.S. **early-phase sectors, like Materials, Energy, and Industrials**. We have also added to late-phase sector exposure, and, in balanced portfolios, have moved to an **overweight of fixed income**.

Given the record amount of fiscal support during the pandemic and the magnitude of the economic recovery, we expected the pace of economic growth would shift lower, as is typical as the economic cycle matures.

Year-over-year growth and 6-month annualized growth for the Leading Economic Index (LEI) have both entered negative territory. The chart above illustrates that negative levels of 6-month growth in LEI can occur in and out of recessions, but, at the same time, it does indicate that the U.S. economy is potentially at a key juncture.

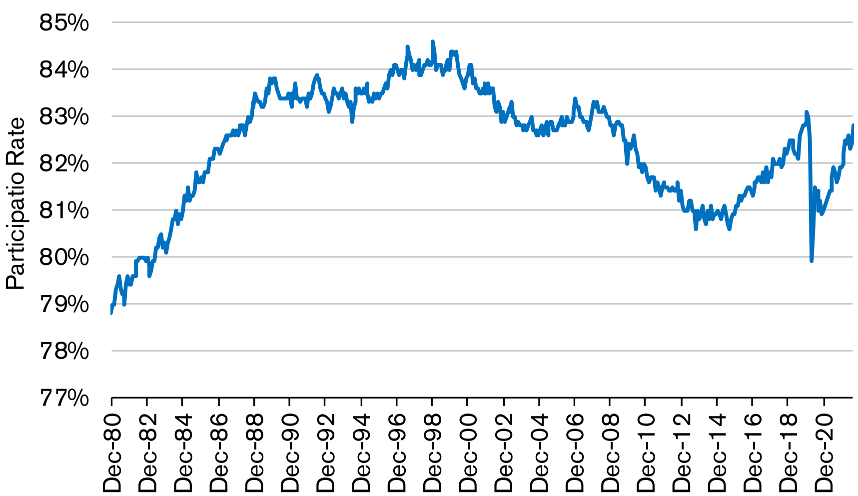
# Labor Market Strength is Key Support for Economy

## INITIAL JOBLESS CLAIMS




Source: DOL, WestEnd Advisors

## PRIME AGE PARTICIPATION RATE




Source: WestEnd Advisors, Bureau of Labor Statistics

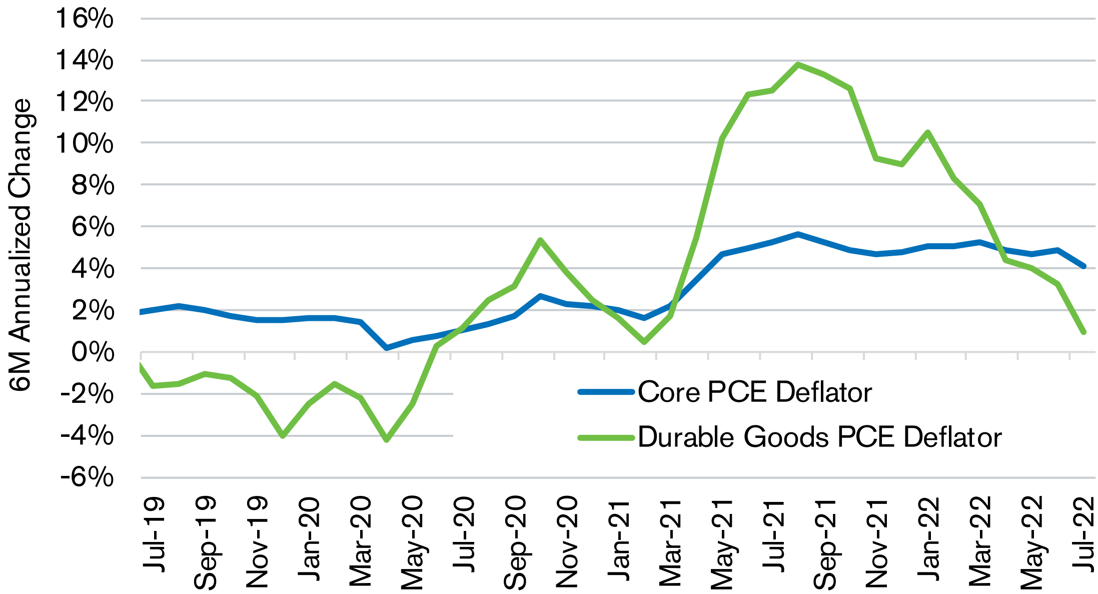
**Portfolio Impact:** While risks have increased across the economy, the labor market remains sound. **The strong employment backdrop should support consumer-related sectors like Consumer Discretionary and Communication Services**. In our view, the labor market will be a key determinant of the U.S. economy's path and whether a recession is avoided in the intermediate term.

Labor markets remain strong. Layoffs are low by historical standards (top chart) and, although inflation has weighed on consumer sentiment readings, consumers continue to spend at a healthy pace. If layoffs increase and **consumers' sense of job security** declines materially, we would see that as a **more serious threat to spending and the economy overall**.

**Even with labor market strength, a greater supply of workers could lessen inflation pressures and support an extension of the cycle.** While there has been a strong recovery in prime-age participation thus far this cycle, participation can rise further as the measure is still below pre-pandemic levels and materially below prior cycles (bottom chart).

# Inflation Decelerating as Pandemic Challenges Ease

## PANDEMIC DRIVERS OF INFLATION STARTING TO FADE




Source: WestEnd Advisors, Bureau of Economic Analysis

**Portfolio Impact: Allocations to Health Care, Utilities, and Information Technology** should benefit, in our view, as inflation and growth continue to decelerate, given their **favorable business fundamentals and less cyclical earnings streams.**

**We see inflation heading lower** in the latter part of 2022 and into 2023. A primary driver of elevated inflation readings in 2021 and the first half of 2022 was the surge in the price of durable goods, most notably new and used automobiles. Extraordinary demand for these types of goods, combined with constrained supply chains, pushed measures of core inflation to readings not seen since the 1980s.

We are encouraged by recent decelerating growth trends in these goods categories, in part from more difficult year-over-year comparisons, but also from softer demand for goods and healing supply chains. Despite these positive trends, the **Fed is signaling** that it will implement significantly **more aggressive monetary policy tightening**, in our view, than it targeted in its forward guidance in the first half of 2022.

# Federal Reserve has Embarked on a Record Tightening Plan

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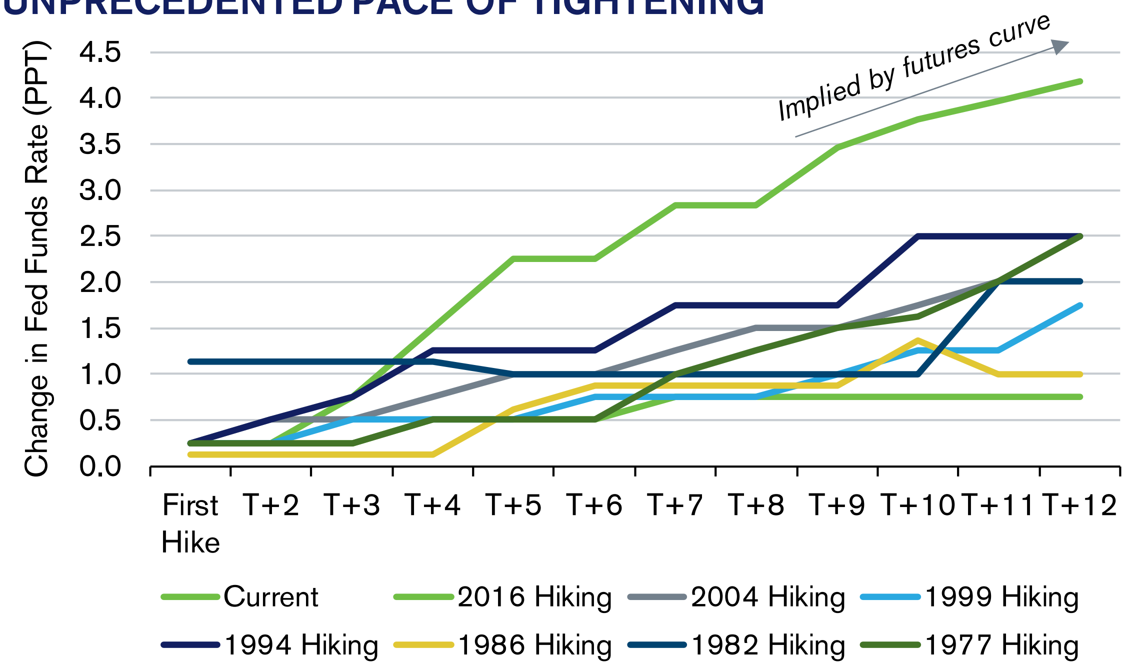
## UNPRECEDENTED PACE OF TIGHTENING




Source: WestEnd Advisors, Bloomberg. Futures curve as of 9/30/22.

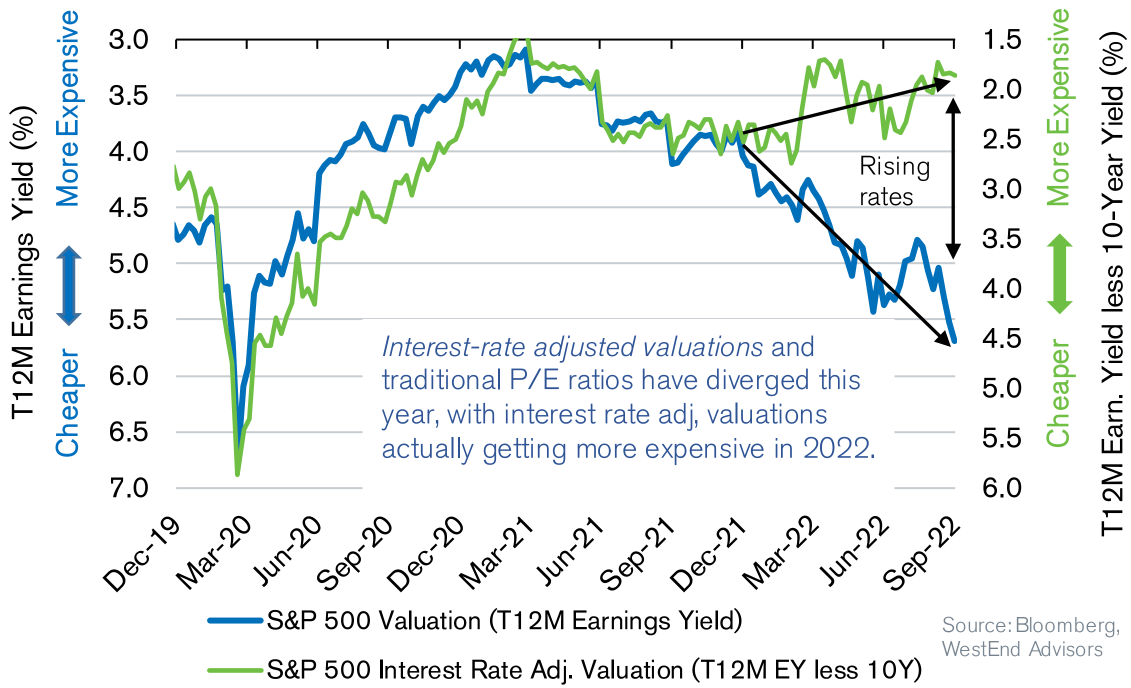
**Portfolio Impact:** We believe slowing economic growth combined with **the pace of the Fed's planned tightening cycle warrant an exit of high yield bonds and avoidance of U.S. cyclical early-phase sectors,** which we see as challenged whether growth persists or if there is an economic downturn.

The **Fed's recent shift toward more aggressive monetary tightening has heightened risks** that the economy advances faster towards recession, in our view. In fact, the chart above illustrates that the market is discounting what would be the sharpest hiking cycle in a half century.

In this environment, we see increased risk to corporate earnings and, particularly, to the performance of economically sensitive parts of the financial markets.

# Interest Rates Have Driven the Majority of the Market Sell-Off Year-to-Date

**EQUITIES' RATE-ADJUSTED VALUATIONS HAVE RISEN YTD**




Source: Bloomberg, WestEnd Advisors

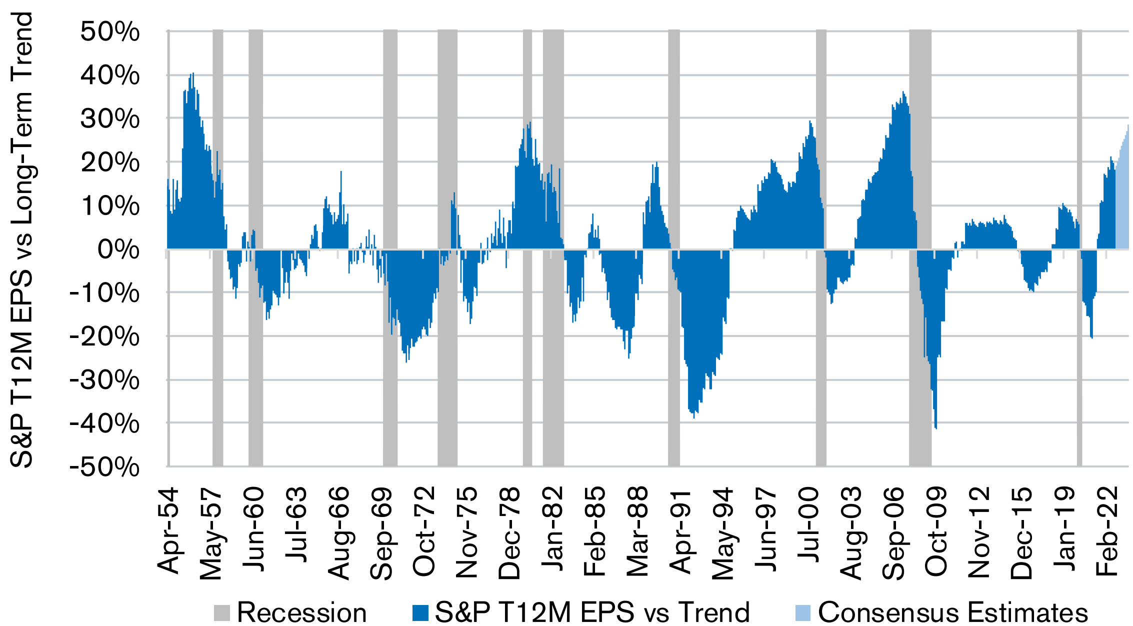
**Portfolio Impact:** Interest rates have driven equity markets lower this year, but looking ahead**, earnings declines could be a catalyst** for additional challenges, in our view. We believe **earnings risk is concentrated in cyclical sectors,** which have seen large increases in earnings expectations in part due to fluctuations in commodity prices and above-trend growth.

We see much of the **year-to-date equity market performance as driven by markets adjusting to higher interest rates**, as opposed to the market pricing in an earnings deterioration. The chart above shows that when adjusted for interest rates, the valuation for the S&P 500 has become *less* attractive compared to where it was at the beginning of the year.

The rapid rise in interest rates has weighed on stock prices, even though the market overall has seen **a +6% rise in consensus 12-month forward earnings estimates since the beginning of the year**. In the event that the economic backdrop deteriorates, we believe investors will begin to focus on earnings declines in more cyclical sectors, such as Energy, Industrials, and Financials.

# 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 Energy, Industrials, and Financials, and we have **increased exposure to sectors with more durable earnings power**, such as Utilities and Consumer Staples.

S&P 500 profits have rebounded swiftly since the depths of the pandemic. As of September, 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 (~8% year-over-year). 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, earnings estimates could be at risk.

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# U.S. Sector Outlook

# Late-Phase Sectors Provide Steady Earnings

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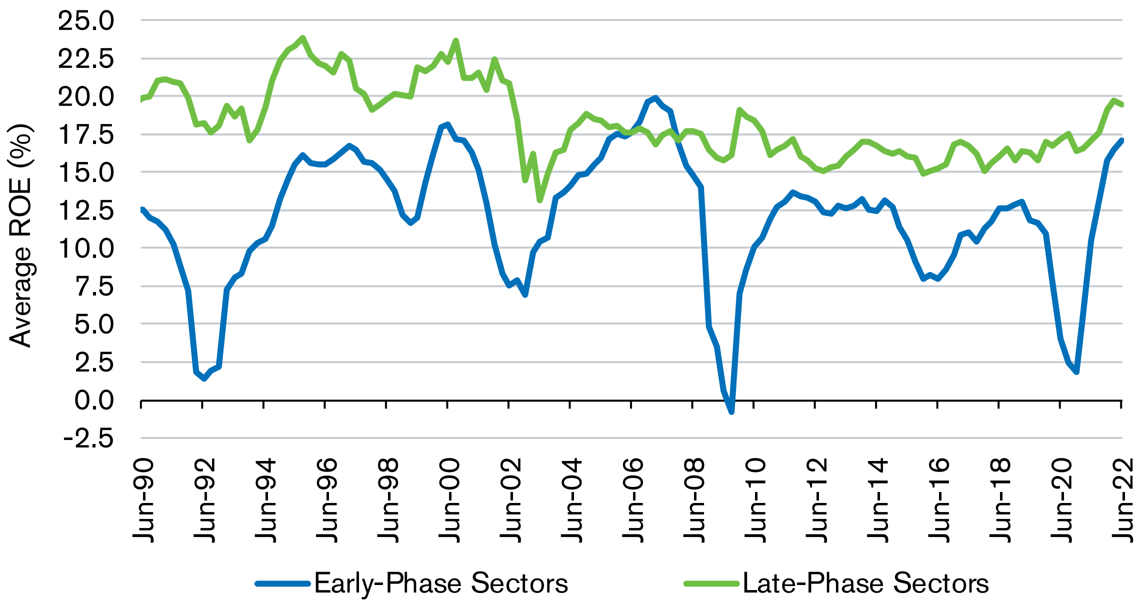
## RETURN ON COMMON EQUITY




*Early-phase sectors include Energy, Materials, Industrials, and Financials.*

Source: WestEnd Advisors

**Portfolio Impact:** We believe exposure to defensive areas of the market – such as Health Care, Consumer Staples, 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, Consumer Staples, 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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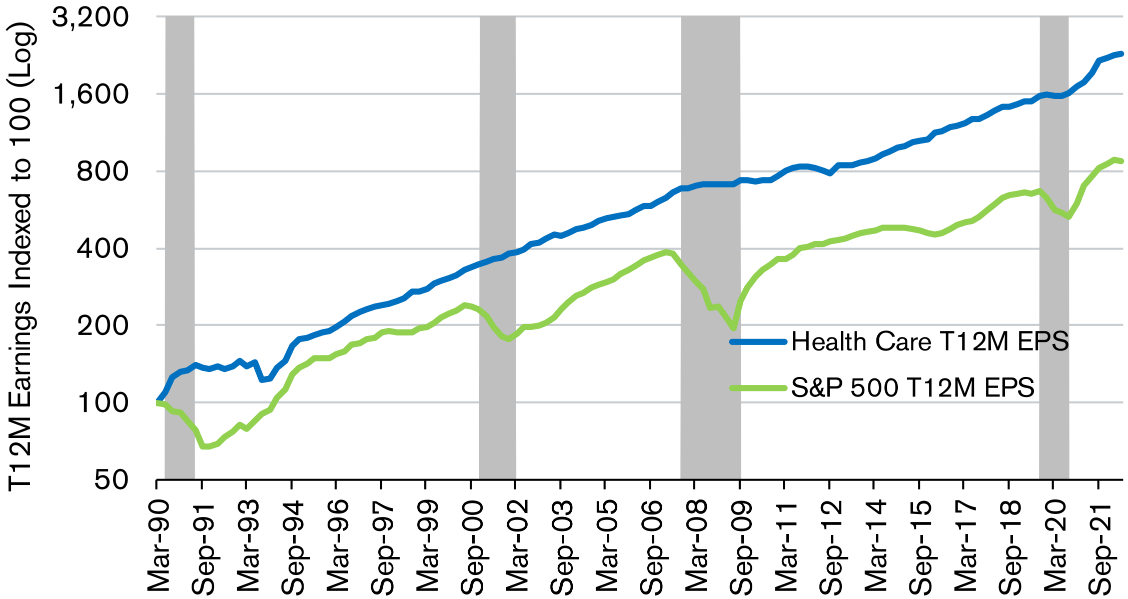
**STEADY HEALTH CARE EARNINGS, EVEN IN RECESSIONS**




*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 a further tailwind to the sector coming from pharmaceutical and biotechnology companies resuming projects previously put on hold to focus on the Covid-19 response.



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# Mid-Phase Sectors Have a Mix of Economically Sensitive and Non-economically Sensitive Revenue

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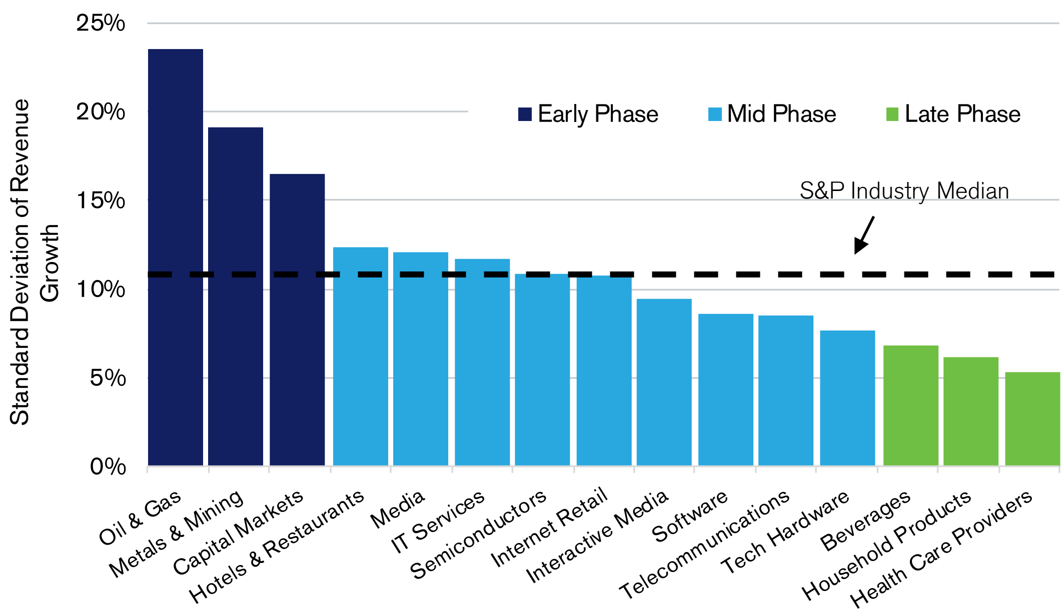
## SELECT INDUSTRY REVENUE VOLATILITY




Source: WestEnd Advisors

**Portfolio Impact:** As economic growth continues to slow, **we believe Information Technology and Communication Services will see less revenue and earnings growth deceleration than other economically sensitive areas of the market** due to strong secular growth trends benefitting these sectors. As a result, we continue to **maintain an allocation to Information Technology and Communication Services**, which we currently see at attractive valuations.

The chart above highlights that the revenue variability of companies in early-phase sectors is typically much greater than those in late-phase sectors. For example, Oil & Gas industry revenue growth is nearly 5 times as volatile as Health Care Providers industry revenue growth. **Mid-phase sectors tend to have less cyclical revenue exposure than early-phase sectors**, but more sensitivity to economic growth than late-phase sectors. We see the lower revenue volatility and more secular-oriented growth profiles for these mid-phase sectors as attractive versus early-phase sectors at this stage in the cycle.

Businesses and consumers have increasingly embraced digital platforms in recent years, and **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.**

# Expect a Deterioration in Energy Sector Fundamentals Ahead

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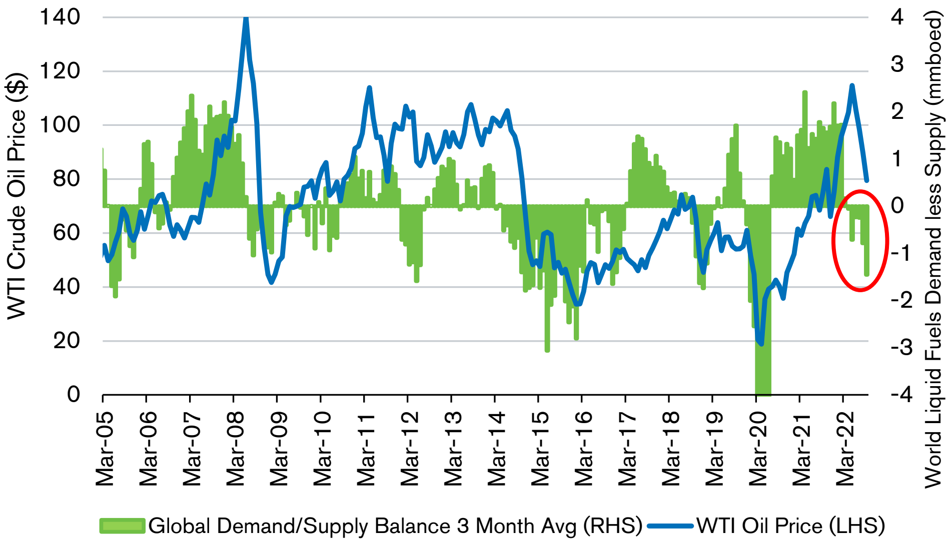
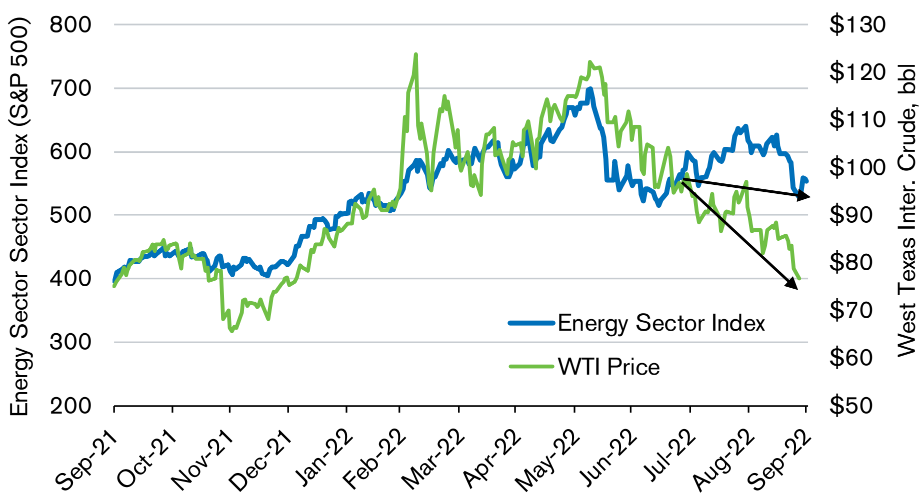
## ENERGY MARKETS ARE BECOMING MORE BALANCED




Source: EIA, WestEnd Advisors

## ENERGY SECTOR INDEX VS. CRUDE OIL PRICE




Source: WestEnd Advisors, Bloomberg

**Portfolio Impact:** We **eliminated U.S. Energy sector exposure** in portfolios as the prospect of slower growth in the U.S. and abroad increases the likelihood of a deterioration in the earnings outlook for the sector.

As the economy enters the latter stages of this cycle, we believe oil and gas demand growth is likely to decelerate, even as more supply is set to come online. In fact, in recent months, global **oil production has begun to outpace consumption** after two-and-a-half years of supply deficit.

The shift from a historically tight energy market to one that is more balanced should put further downside pressure on oil and gas prices as well as sector earnings. In our view, **Q2 2022 likely marked the highwater mark for Energy sector EPS growth this cycle**, and analysts' elevated EPS estimates appear too optimistic.

In recent months, the **decline in the price of crude oil (WTI) has outpaced the move lower in the S&P 500 Energy sector**, which presents another risk for Energy stocks (bottom chart).



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# International Economic & Market Backdrop

# US Dollar Strength is a Headwind for Earnings

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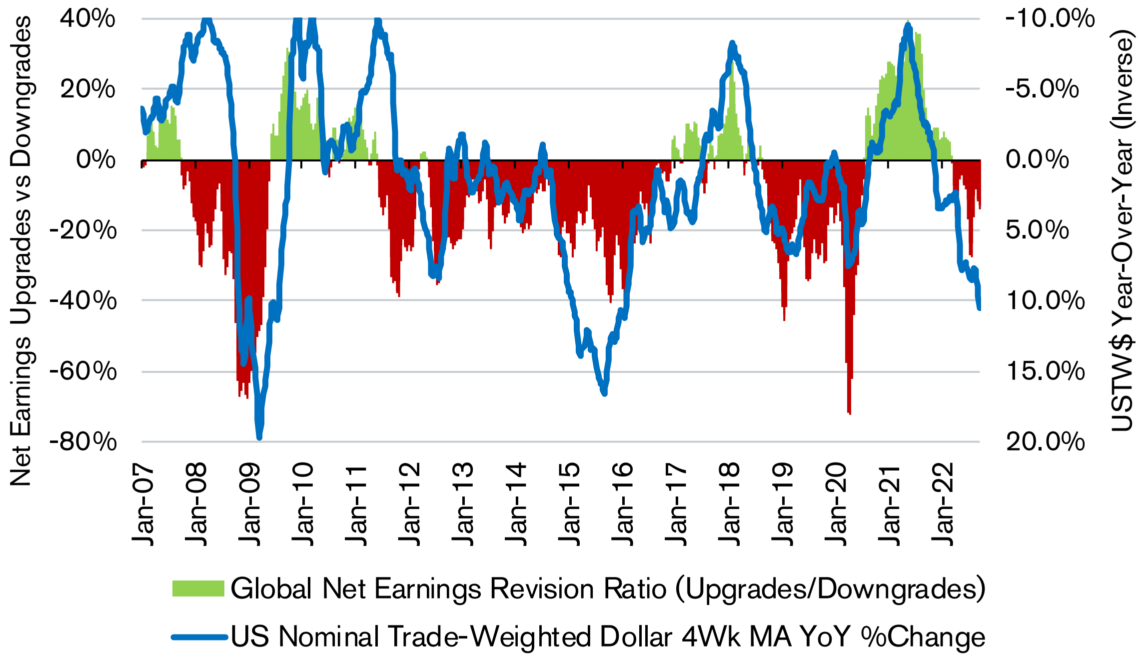
## DOLLAR STRENGTH IMPLIES GLOBAL EARNINGS DOWNGRADES




Source: WestEnd Advisors

**Portfolio Impact:** While the rising U.S. dollar should benefit U.S. importers, we see it as a **likely headwind to global earnings growth over the next several quarters.** As such, in global portfolios, we remain **overweight to the U.S. and underweight to emerging markets**, which may be at risk of further currency depreciation if the global economic backdrop continues to weaken.

The U.S. Dollar Index has surged nearly 18% since the beginning of 2022 – the most in any nine-month period since 2015 – due to a rapid Federal Reserve tightening cycle and concerns about global economic growth.

While an appreciating dollar is beneficial for U.S. consumers and businesses that import goods and services, it is also a headwind to the sales and earnings of U.S. based-firms that do business overseas. **Periods in which the U.S. dollar is strengthening have historically been associated with net global earnings downgrades (see chart).**

The rising U.S. dollar is also likely to have negative knock-on effects for economic growth abroad, especially for countries that rely on imported energy and emerging market countries at risk of capital outflows.

# Economic Activity in Japan Should Prove Resilient

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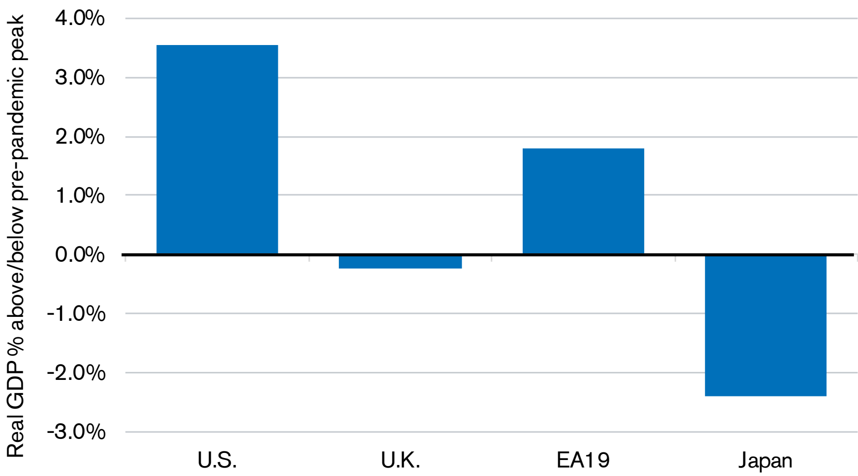
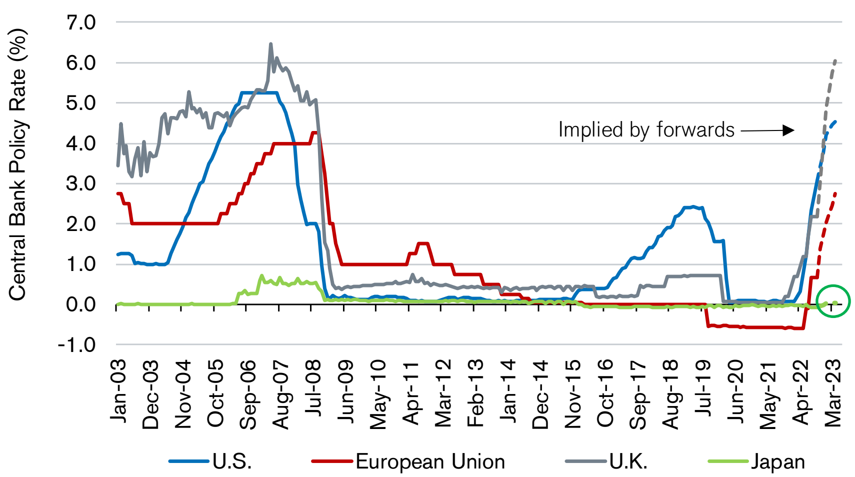
### REAL GDP REMAINS DEPRESSED IN JAPAN




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

### FED, ECB, AND BOE EMBARKING ON RECORD TIGHTENING CYCLE




Source: WestEnd Advisors

**Portfolio Impact:** An **overweight allocation to Japan** is warranted, in our view, given that its economy faces **fewer economic headwinds from inflation and monetary policy tightening.** We believe this will allow the economic recovery to continue, and we expect companies in Japan to generate stronger sales and earnings growth relative to other international regions.

In a maturing global cycle, it is important to **emphasize regions that can generate resilient earnings growth in the face of rising global economic risks**, in our view.

Japan has recorded a slower economic rebound than the rest of the developed world due, in part, to COVID restrictions, and we believe its recovery could continue into 2023. **Real economic activity in Japan remains depressed versus pre-pandemic levels (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, a more accommodative monetary policy stance due to slower inflation (see bottom chart), more attractive exports due to currency depreciation, and the re-opening of Japan's travel industry, could provide fuel to Japan's spending upswing.

# Europe Faces Significant Economic Risks as Winter Approaches

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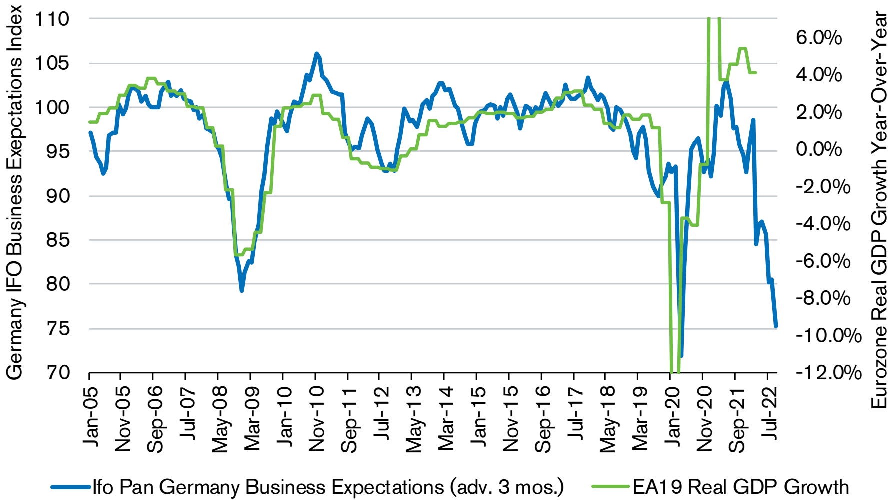
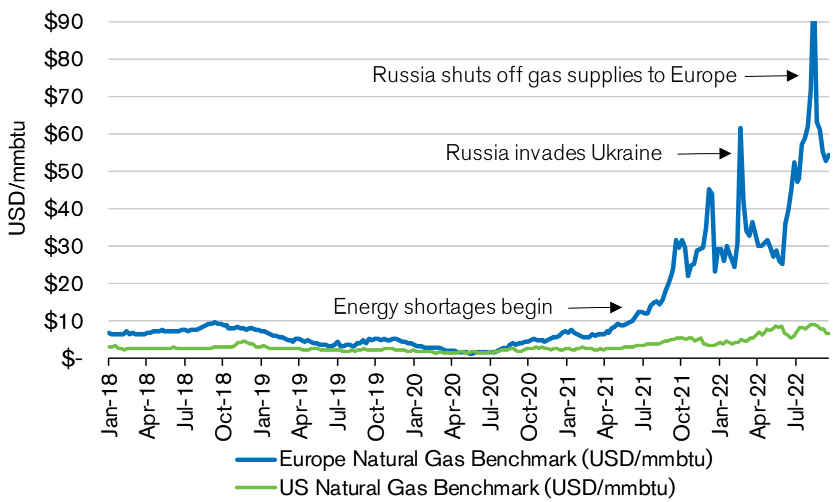
### EUROPEAN BUSINESS EXPECTATIONS ARE RAPIDLY DETERIORATING




Source: ifo Institute, Eurostat, WestEnd Advisors

### EUROPEAN NAT. GAS PRICES NOW 7X HIGHER THAN IN US




Source: WestEnd Advisors

**Portfolio Impact:** We remain **significantly underweight Europe in our global portfolios,** given the region's **near-term growth headwinds and heightened geopolitical uncertainty**. Still, European earnings estimates have remained elevated, which we believe poses a downside risk for equities in the region.

Real GDP growth in Europe was stronger than that of the U.S. in the first half of 2022, but risks are mounting rapidly for households and businesses in the region.

The **surge in energy inflation** due to the fallout of the Russia-Ukraine war, as well as the **potential for gas shortages this winter,** could **weigh heavily on European manufacturing activity in the coming quarters**. Production makes up ~30% of Europe's economy. Business expectations for future activity, which has historically led real GDP growth, have fallen sharply over the past several months (top chart).

The household sector is also likely to suffer from higher energy bills. The bottom chart shows that **prices for natural gas in Europe have risen to levels that are nearly 7x higher than those in the U.S.** This has driven consumer sentiment to a record low and could weigh on household spending moving forward.

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# Interest Rates & Inflation

# Peak in Interest Rates May Be Approaching

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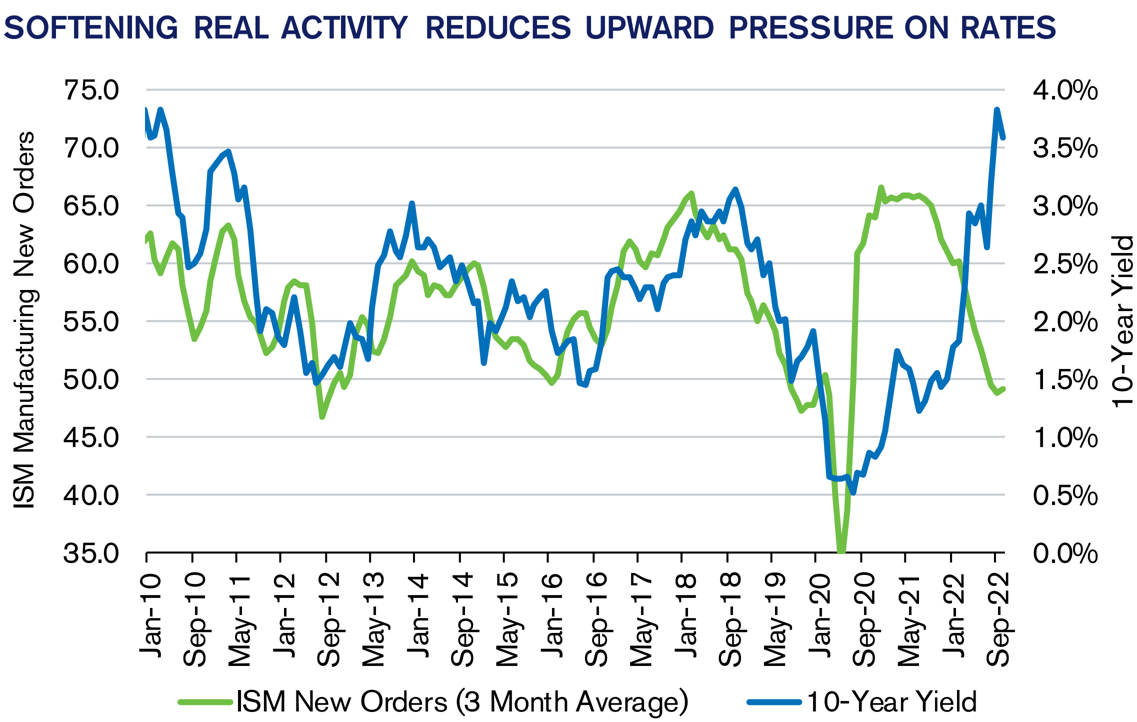



Source: Institute for Supply Management, WestEnd Advisors

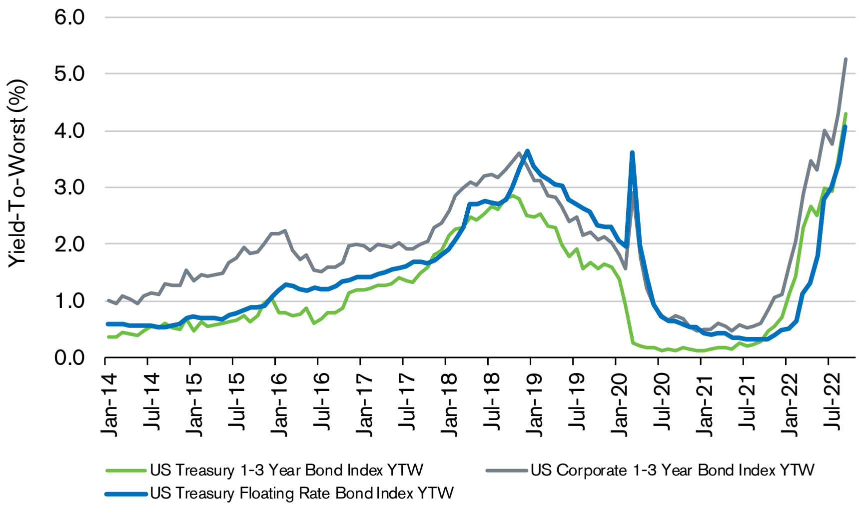
**Portfolio Impact:** Given the worst performance to start the year for U.S. bonds in over four decades and a growing likelihood that the peak in long-term interest rates could be approaching, we believe **risks to fixed income market returns have diminished**. Slowing economic growth and earnings headwinds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

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 longer-term interest rates is likely to diminish as economic growth slows and inflation pressures begin to moderate.

As shown in the chart above, **longer-term 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**.

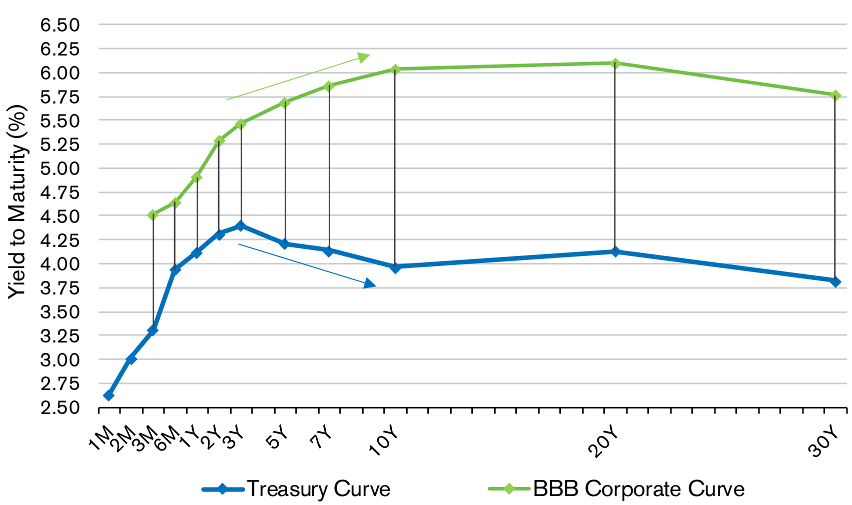
# Rising Rate Environment Creating Opportunities in Fixed Income

## TREASURY FLOATING RATE YIELDS HAVE RISEN RAPIDLY




Source: WestEnd Advisors

## CREDIT CURVE REMAINS UPWARD SLOPING




Source: WestEnd Advisors

**Portfolio Impact:** As the Federal Reserve remains firmly committed to reducing inflation, we see further upside to short-term interest rates and a growing risk of economic deterioration. As such, we have **reduced our overweight of corporate credit and initiated a position in floating-rate Treasury notes.** We have also added to our defensive long-duration Treasury exposure, which we believe will outperform if growth and inflation surprise to the downside.

Even as the late-cycle environment of slowing real growth, tighter monetary policy, and high inflation have increased the uncertainty around bond returns, we see several opportunities to be selective in the fixed income space:

- Yields on **Treasury floating rate notes** are rising rapidly as short-end rates rise (see top chart). Floating rate securities are effectively insulated from duration risk.
- **Intermediate duration corporate bonds** are yielding up to ~200 bps more than the equivalent-maturity Treasury securities (bottom chart) and are also likely higher quality than short-duration credit.
- **Long-duration Treasury bonds** have historically outperformed significantly during recessionary periods, and the risk of a sustained inflationary spiral has diminished, in our view.

# 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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