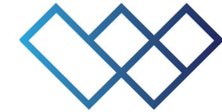

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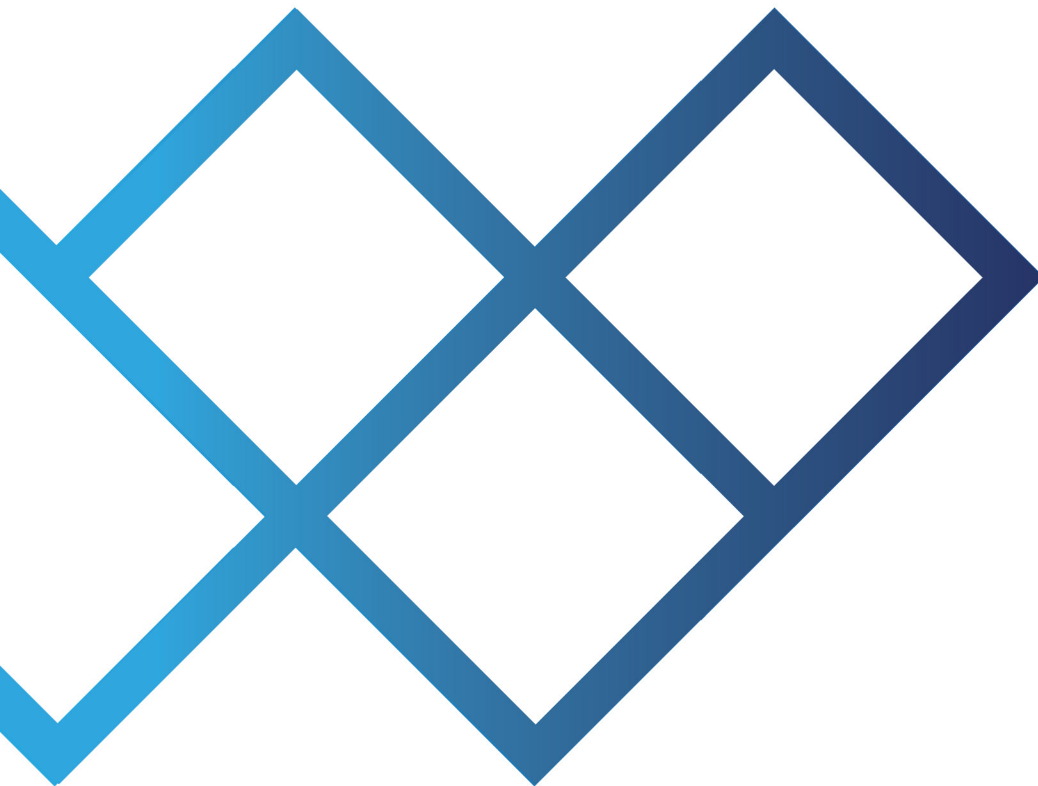

Mid-Quarter Macro Update

Q2 2023

20230522-2916235

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Table of Contents

U.S. Equity Sector Allocations 2

Economic & Market Backdrop

- Economic Cycle: Slowing growth brings challenges and risks 4
- Labor Market: Leading labor market data starting to deteriorate 5
- Economic Growth: Growth drivers increasingly vulnerable 6
- Monetary Policy: Inflation and labor market conditions restrict Fed's flexibility........ 7
- Credit Conditions: Consistent with late-cycle economic deceleration 8
- Interest Rate Outlook: Limited upside risk for long-term rates........ 9
- Late-Phase Sectors: Steady earnings growth 10
- Debt Ceiling: Incremental risk as "X-date" approaches 11

Disclosures 12

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

Sector Avoidance

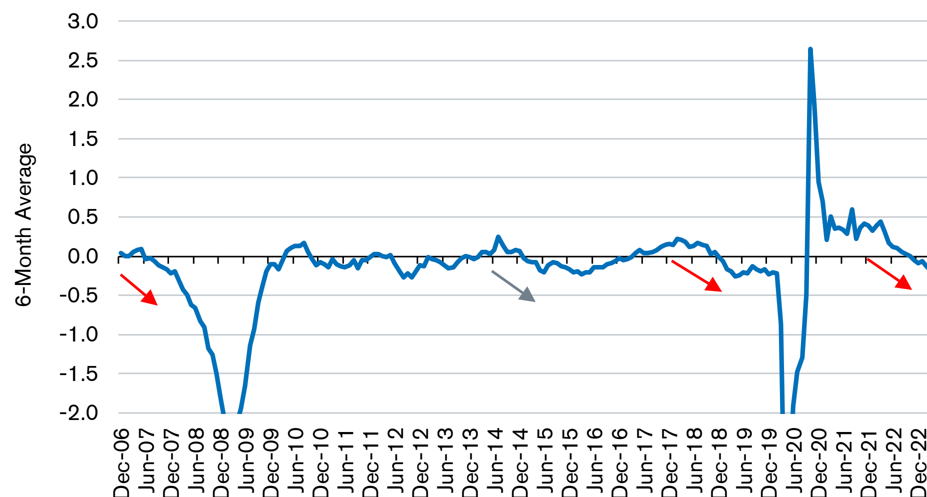
- Energy
- Financials
- Industrials
- Materials
- Real Estate

* For illustrative purposes only. Allocation information as of May 22nd, 2023. Source: WestEnd Advisors.

Economic & Market Backdrop

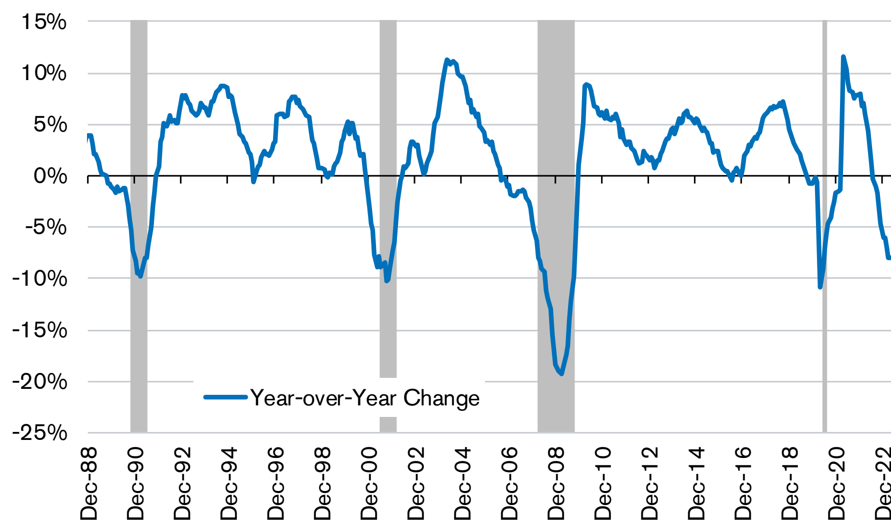
Slowing Economic Growth Brings Increased Challenges and Risks

CHICAGO FED NATIONAL ACTIVITY INDEX



Source: Chicago Federal Reserve Bank, WestEnd Advisors

LEADING ECONOMIC INDEX



Source: Conference Board, WestEnd Advisors

Portfolio Impact: Increased risk of recession in the U.S. 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**.

Broad measures of U.S. economic activity like the Chicago Fed National Activity Index weakened in recent quarters. Despite the volatility in quarterly GDP readings, **we continue to see late-cycle economic conditions in place in 2023.**

Meanwhile, the Leading Economic Index (LEI), a more forward-looking indicator, has deteriorated over the last year as the Fed has tightened monetary policy and interest rate-sensitive parts of the economy have weakened. The bottom chart illustrates that LEI growth has fallen to a level that historically has coincided with recessions. We believe the prospect of economic retrenchment **increases the risk to earnings in future quarters, particularly for companies in economically sensitive sectors of the economy.**

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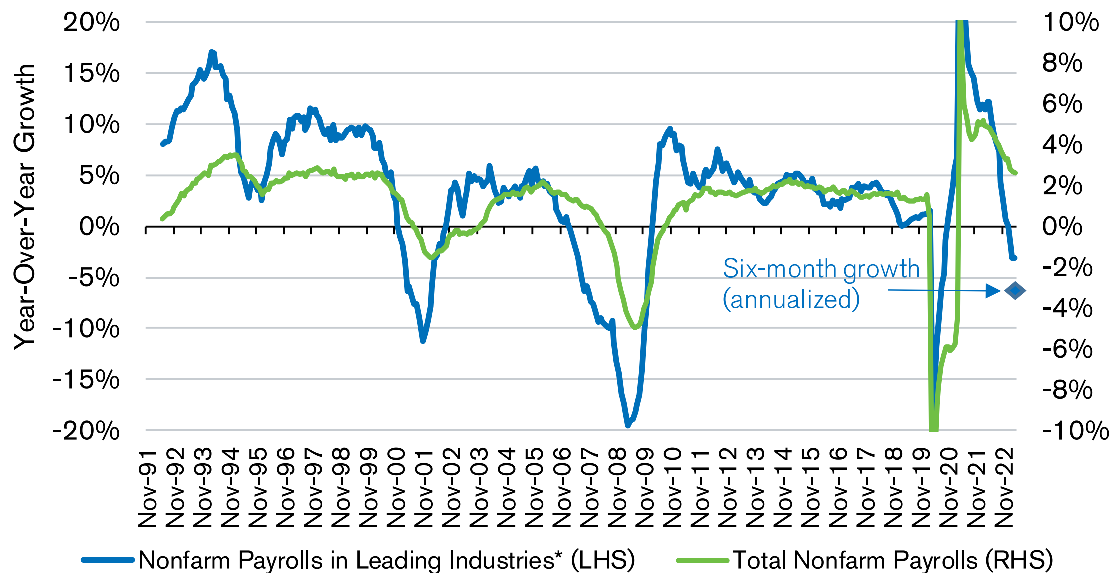
Leading Labor Market Data Starting to Deteriorate

JOB GROWTH RAPIDLY SLOWING IN LEADING INDUSTRIES



Portfolio Impact: Job growth remains a major pillar supporting economic growth in the U.S., but the **risks to the labor market have started to increase**, in our view. The trajectory of employment and layoffs is likely to be a key determinant of the U.S. economy's path and whether a recession is avoided in the intermediate term.

**Includes temporary help services, warehousing & storage, nondepository credit intermediation, logging, and professional employer organizations*

Source: BLS, WestEnd Advisors

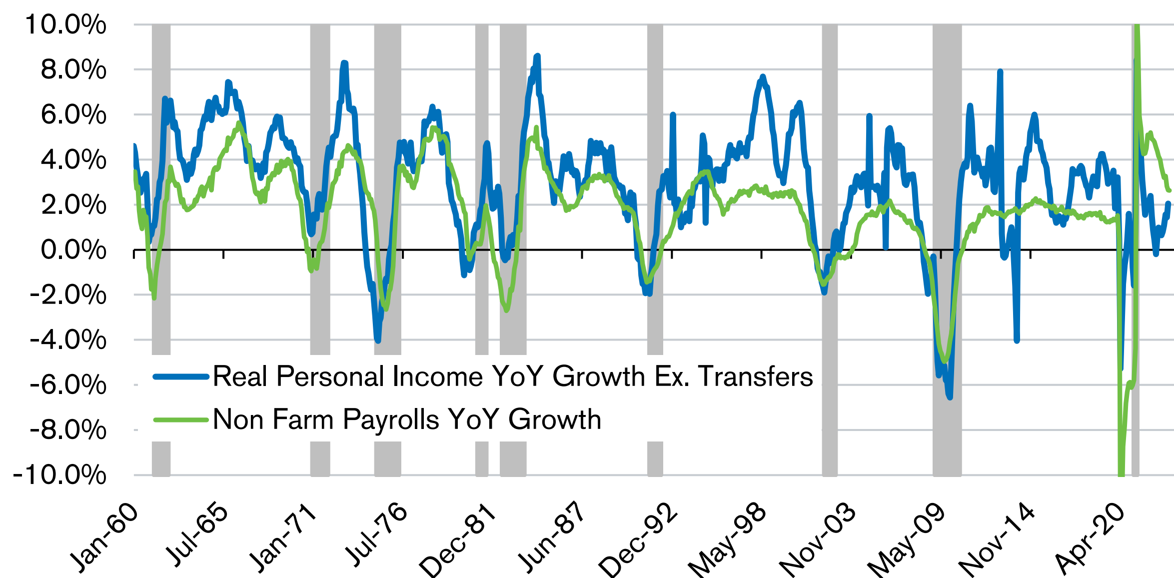
While total nonfarm payroll growth – a historically *lagging* indicator – remains above the long-term trend, signs of incremental softening in the job market have started to show up in the more leading labor market data.

Payroll growth has decelerated sharply among sub-industries that have historically provided leading signals for the overall job market, including temp workers, credit intermediation, and warehousing & storage (see chart).

If layoffs increase and **consumers' sense of job security** declines materially, that could pose a **serious threat to spending and the economy overall**.

Economic Growth Drivers Have Been Resilient But Are Increasingly Vulnerable

REAL PERSONAL INCOME GROWTH AT RISK



Source: BEA, BLS, WestEnd Advisors

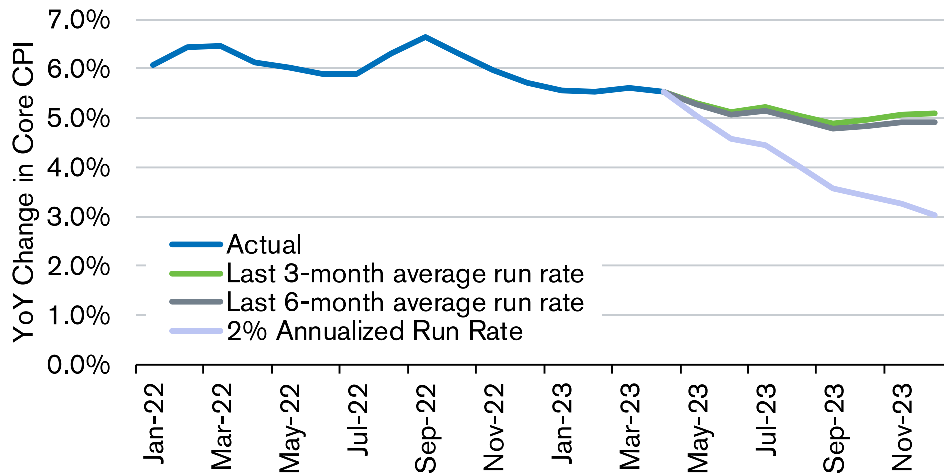
Portfolio Impact: Real measures of income growth have accelerated, thanks in part to recent disinflationary trends, **though we believe this strength is at risk of reversing** if softening in the labor market becomes more widespread. Given this risk, we continue to focus on maintaining a proper balance of defensive and cyclical exposures.

Economic activity has remained resilient in the face of aggressive monetary tightening by the Fed, a dynamic which we attribute in part to an unprecedented accumulation of personal savings from pandemic-era fiscal policy and a strong labor market. As a result, consumer spending continues to be a positive contributor to U.S. economic growth, and recent disinflationary trends could provide additional support to the consumer.

However, signs of softening in the labor market that we are seeing (per the previous slide), **as well as declining corporate profit margins, could ultimately weigh on both consumer spending and corporate profits**. A weakening labor market has typically been associated with declining real personal income growth, as seen in the chart above.

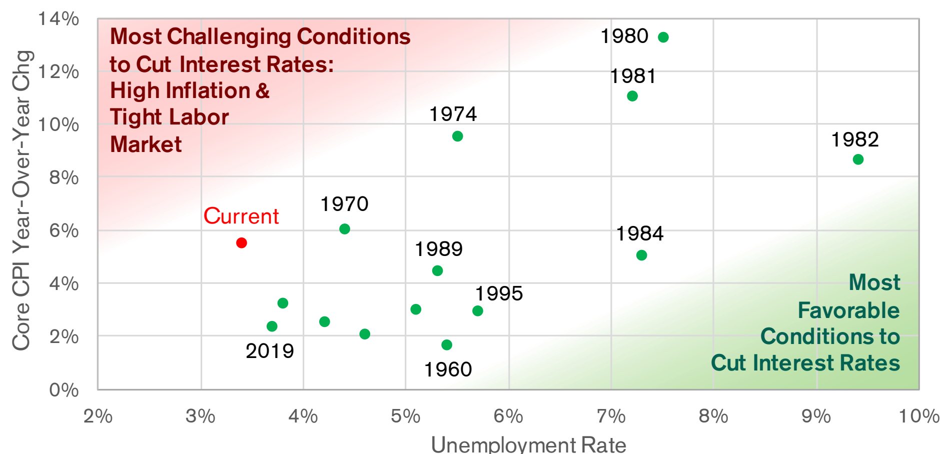
Inflation and Labor Market Conditions Restrict the Fed's Flexibility

DISINFLATION IS PROCEEDING SLOWLY



Source: BLS, WestEnd Advisors

HISTORICAL INFLATION & UNEMPLOYMENT FOR 1ST RATE CUTS



Source: Bloomberg, WestEnd

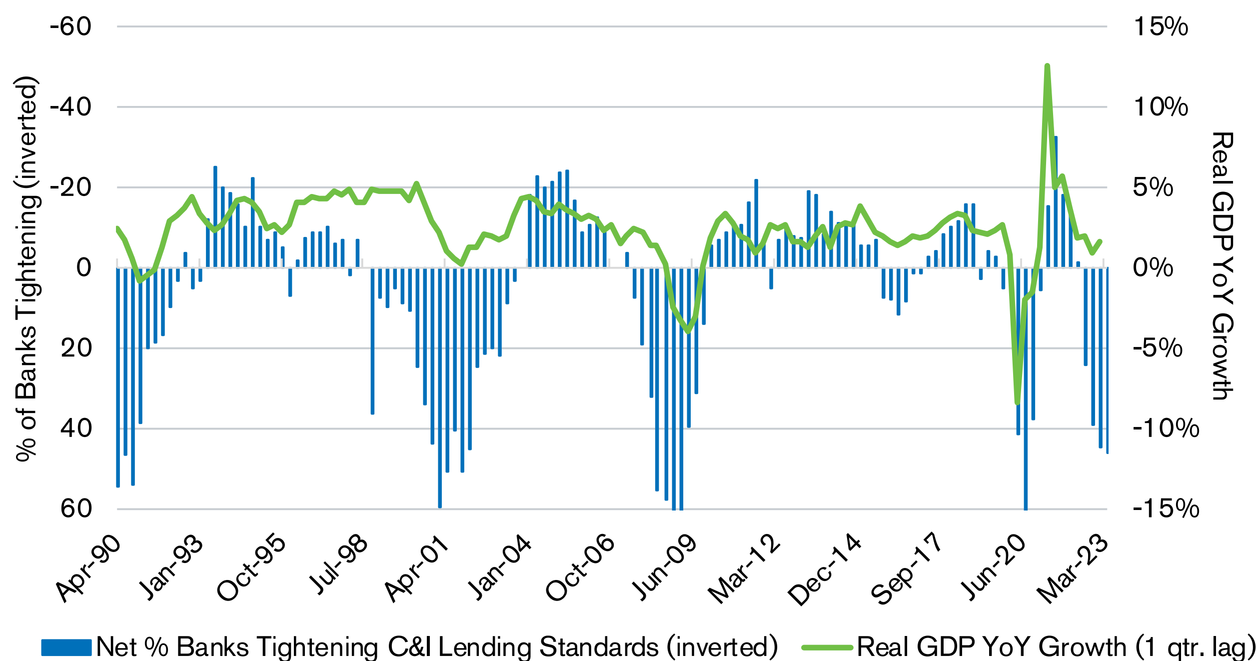
Portfolio Impact: Allocations to the more defensive **Health Care, Utilities, and Consumer Staples** sectors are warranted, in our view, given the risks to economic growth tied to the pace and magnitude of the current tightening cycle, as well as our expectation that **monetary policy will remain restrictive** barring serious economic deterioration.

Measures of core inflation have decelerated modestly over the past several months as goods inflation has slowed, though services inflation remains elevated. **Even with this deceleration, recent trends continue to point to year-over-year inflation remaining well above the Fed's stated target** in the near-to-intermediate term.

The current combination of low unemployment and elevated inflation is not consistent with conditions typically seen when the Fed has started rate cutting cycles in the past. While the Fed may be pausing rate hikes, **if the Fed started *cutting* interest rates now, today's 3.4% unemployment rate would be a record low for the start of a rate cut cycle**. We therefore would expect to see a more pronounced deterioration in economic fundamentals before the Fed starts cutting interest rates.

Tightening Credit Conditions Consistent with Late-Cycle Economic Deceleration

LENDING TIGHTENING POINTS TO SLOWER GROWTH



Source: Federal Reserve, BEA, Bloomberg, WestEnd Advisors

Portfolio Impact: Lending standards had begun tightening even before the recent banking turmoil, and we see this trend persisting in the face of **liquidity strains and waning confidence in the economic backdrop.** We are generally avoiding U.S. Financials, as well as capital-intensive sectors that we believe are **the most vulnerable to the impacts of credit tightening**.

The recent turmoil in the banking industry is unsurprising after a period of significant monetary policy tightening. While we do not expect this to lead to a full-blown credit crisis, we do see uncertainty for banks driving further tightening of lending standards. That, in turn, is likely to exacerbate the growth headwinds that have developed as the economic cycle has advanced and could increase the risk of recession.

Market data and the Fed's survey of lending officers indicate that credit conditions continue to tighten, and **periods of tighter lending standards have historically been associated with slowing economic growth and recession.**

Limited Upside Risk for Long-Term Interest Rates

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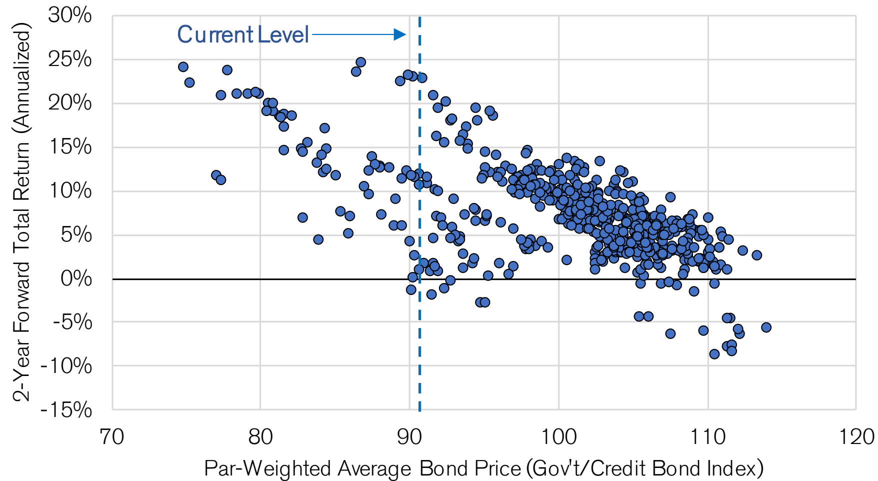
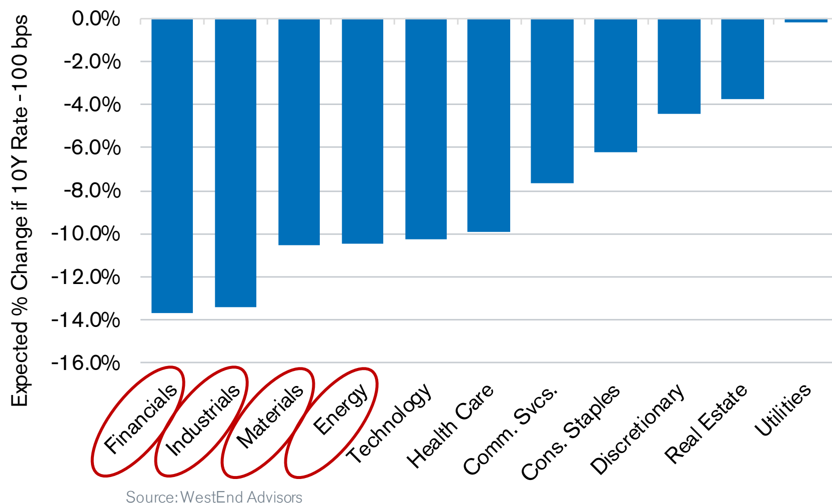
POTENTIAL RETURNS FOR FIXED INCOME ARE ATTRACTIVE



Source: Bloomberg, WestEnd Advisors

SECTOR SENSITIVITY TO INTEREST RATE DECLINES



Source: WestEnd Advisors

Portfolio Impact: Given recent disinflationary trends, which we expect to continue, coupled with mounting risks to the economic backdrop, **we see limited upside risk to long-term interest rates** moving forward. As a result, **we maintain an overweight allocation of fixed income** in balanced portfolios, while avoiding cyclical U.S. equity sectors **that historically have had underperformance associated with declines in interest rates** within our equity allocations.

After a surge in interest rates in 2022, **we believe the risk for long-term rates is likely skewed to the downside within our investment window,** even if the Fed maintains restrictive policy this year. Historically, when average bond prices have been at-or-below levels reached last year, fixed income returns over the subsequent two years have been consistently above-average (top chart). **Thus, we see attractive return opportunities in fixed income given our interest rate outlook**.

Within equities, we see increased risk to earnings, relative to consensus estimates, for the most economically cyclical sectors, which **have historically underperformed when interest rates declined** (bottom chart).

Late-Phase Sectors Provide Steady Earnings

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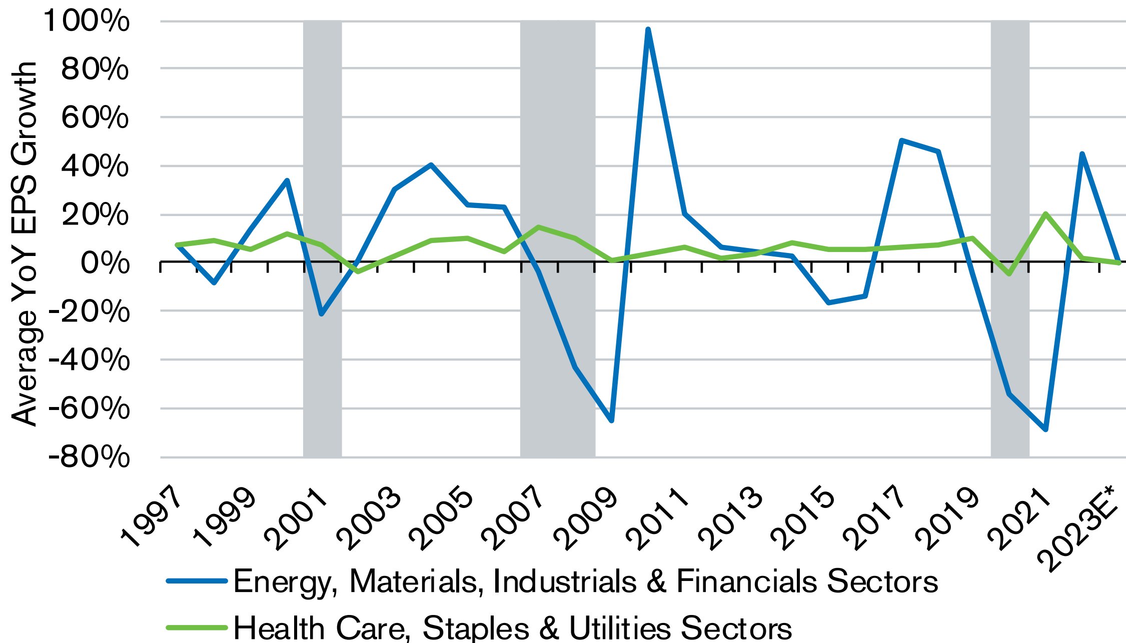
EARNINGS GROWTH BY SECTOR



Source: Bloomberg, WestEnd Advisors

*Consensus estimates for 2023 sector EPS.

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

We see the financial stability of Health Care, Consumer Staples, and Utilities as desirable, particularly in the context of declining levels of real economic activity.

Defensive sectors have generated highly consistent EPS growth over time. In contrast, **economically sensitive sectors** like Energy, Materials, Industrials, and Financials **have much more cyclical earnings**, as illustrated in the chart above.

Debt Ceiling "X-Date" Approaching

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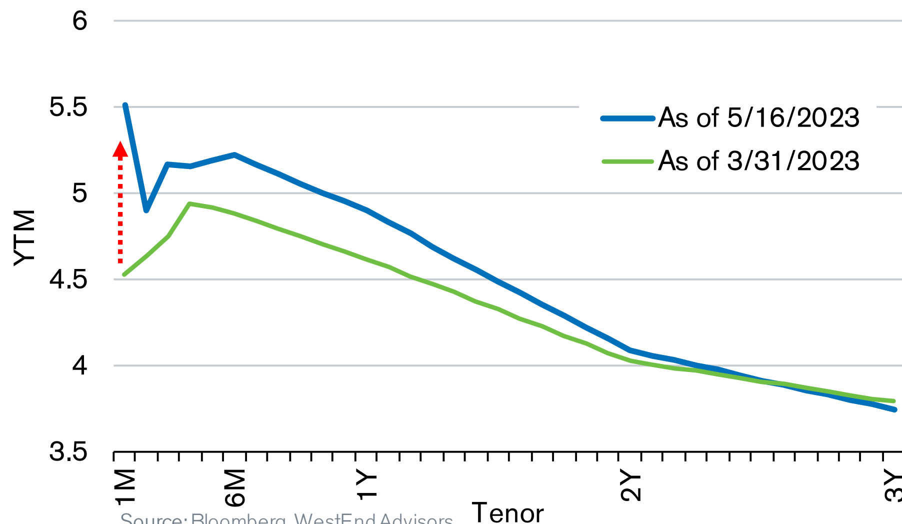
U.S. TREASURY CASH BALANCE ($B)

Source: Treasury Department, Bloomberg, WestEnd Advisors (most recent data as of 5/18/23)

YIELD CURVE REFLECTING DEBT CEILING RISK



Source: Bloomberg, WestEnd Advisors

Portfolio Impact: The ongoing debt ceiling stand off presents incremental near-term risks to the market and broader economy, in our view. **We continue to emphasize defensive areas of the market** that we believe could help insulate portfolios from heightened volatility.

Though not a key pillar of our broader economic views, **the ongoing debt ceiling stalemate has introduced incremental risks to market sentiment** and the progression of the current economic cycle.

The yield curve is reflecting increased risk of a near-term default via higher yields on 1-month T-bills (bottom chart). **Equity volatility has been more subdued, though this could quickly change** as we approach the Treasury's "X-Date".

Political brinkmanship remains high with both divided government and slim majorities in each of the houses of Congress ahead of elections next year. We expect this is most likely to culminate in a pickup in market volatility, but a final resolution in the 11th hour.

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Footnotes & Disclosures

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