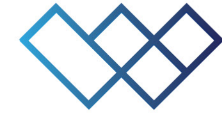

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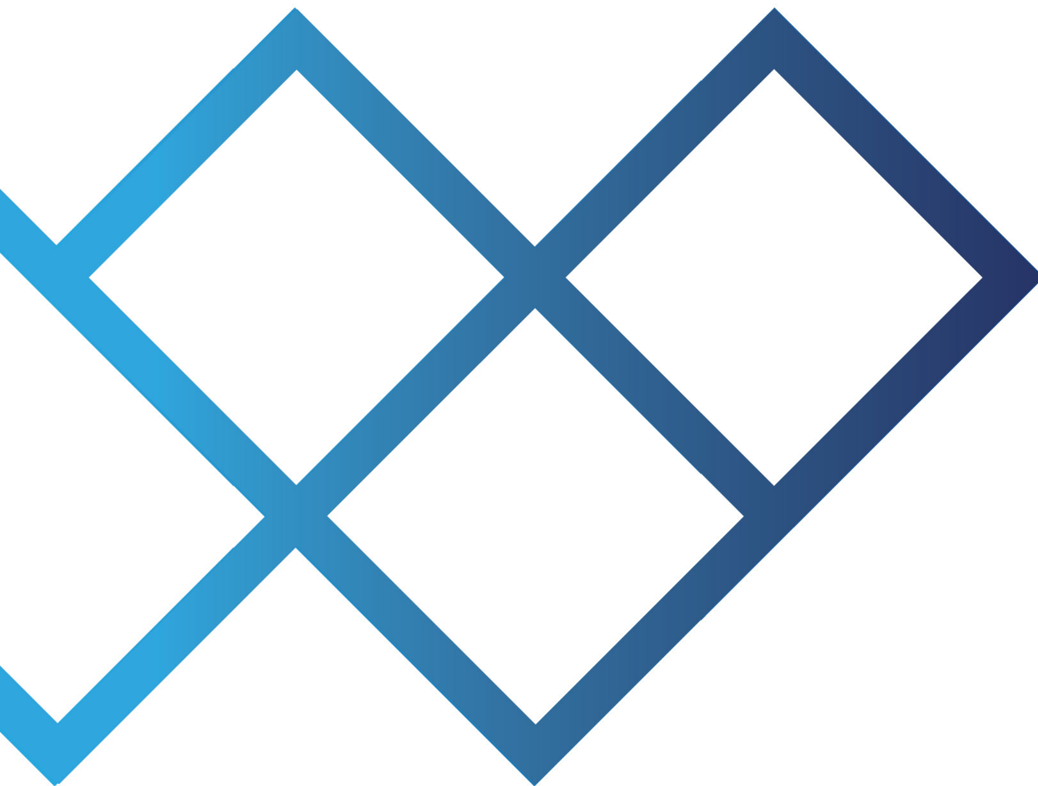

Mid-Quarter Macro Update

Q3 2023

20230821-3073645

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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 August 18, 2023. Source: WestEnd Advisors.

Economic & Market Backdrop

Slowing Economic Growth Brings Increased Challenges and Risks

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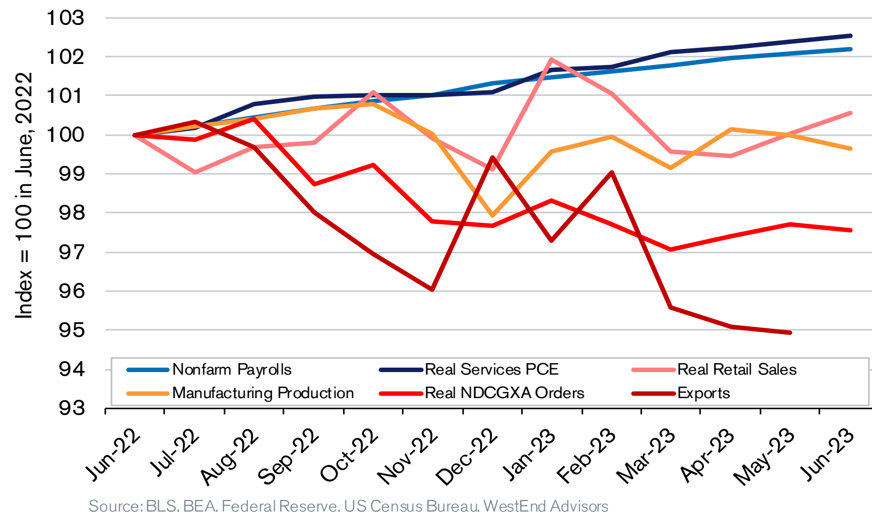
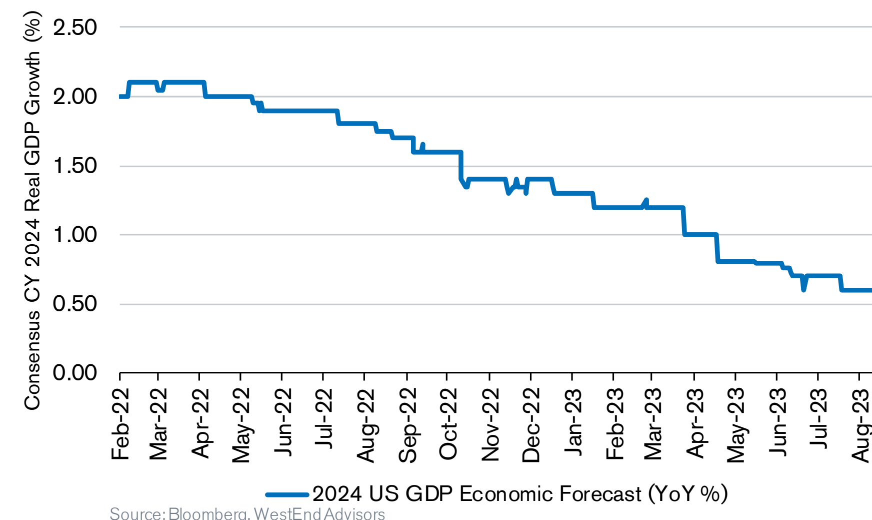
DIVERGENCE AMONG KEY ECONOMIC GROWTH DRIVERS



2024 REAL GDP GROWTH ESTIMATES TRENDING LOWER



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**.

A review of major drivers of GDP growth (top chart) shows a **divergence between** the red data series that have weakened in recent quarters (including **goods consumer spending, manufacturing, investment and exports) and services consumer spending and the labor market**, which are among the few positive growers in this late-cycle environment.

Despite weakness in underlying growth drivers and deteriorating expectations for economic growth in 2024, analysts' double-digit earnings growth estimates for next year appear ambitious as GDP growth expectations move lower (bottom chart). **As such, we believe earnings growth could be a source of disappointment for investors in the coming quarters, particularly for cyclical sectors.**

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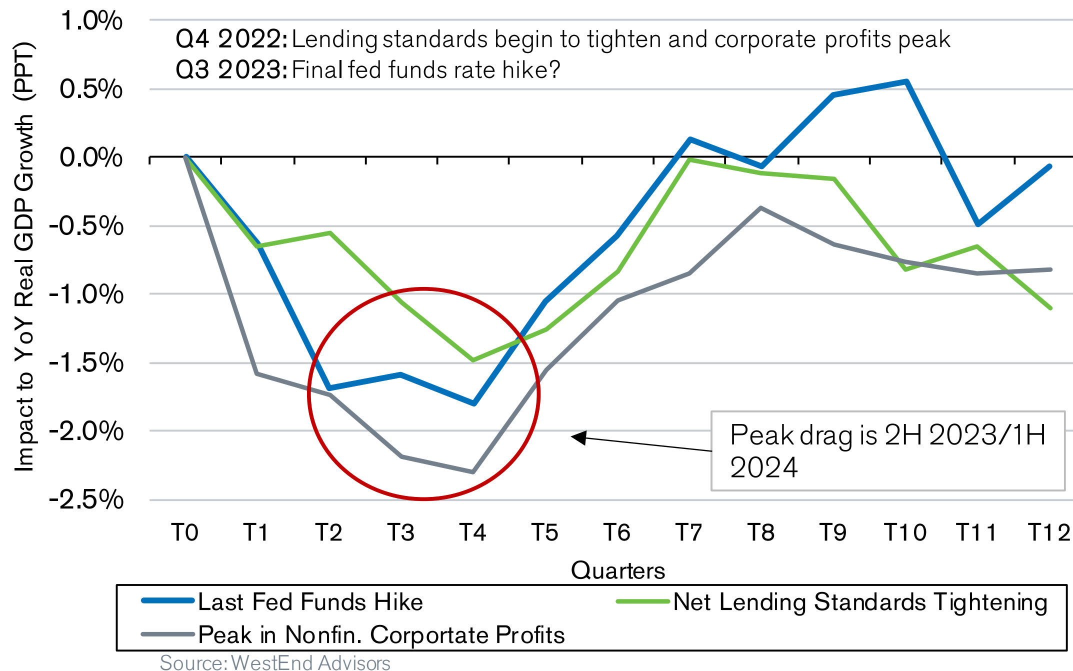
Impending Risks to Growth Still Coming



Portfolio Impact: We believe several risks to economic growth, combined with the Fed's commitment to keeping rates elevated, warrant defensive positioning across our portfolios, given that the **economy has yet to absorb the full impact of monetary tightening.**

There have been several macroeconomic shifts over the past year that we believe *have yet to fully reverberate through the economy*, including: 1) **The fastest monetary tightening cycle since the 1980s;** 2) **a sharp increase in the percentage of commercial banks tightening C&I lending standards;** and 3) **rapidly decelerating corporate profits growth.**

The chart above shows the average historical impact to real GDP growth following 1) the *last* federal funds rate hike of a tightening cycle, 2) the *first* quarter of net C&I loan tightening by banks, and 3) a *peak* in the level of nominal, non-financial corporate profits.

The lagged impact of these developments pose headwinds to economic growth over the next 6-12 months, in our view.

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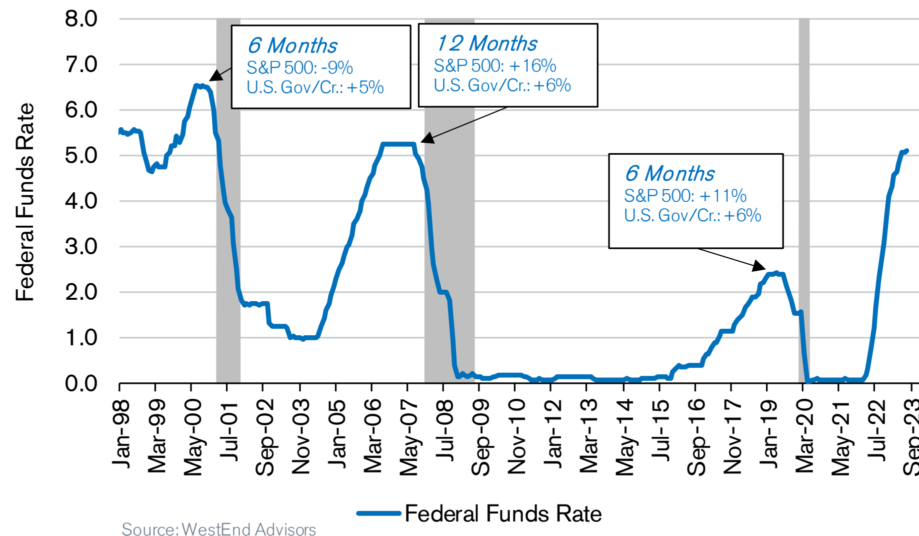
Fed Pause Consistent with Late-Cycle Conditions

LATE-CYCLE ENVIRONMENTS CAN VARY IN LENGTH



Late-Cycle Core Inflation Peaks	Start of Recession	Inflation Peak to Recession (Months)	*Late-Cycle Disinflation S&P 500 Return*
9/30/2022			
7/31/2018	2/28/2020	19	*8.3%*
9/30/2006	12/31/2007	15	*12.6%*
2/28/1989	7/31/1990	17	*29.3%*
6/30/1980	7/31/1981	13	*20.9%*
11/30/1966	12/31/1969	37	*27.1%*
	Average	**20**	***19.6%***

Source: Bloomberg, WestEnd Advisors

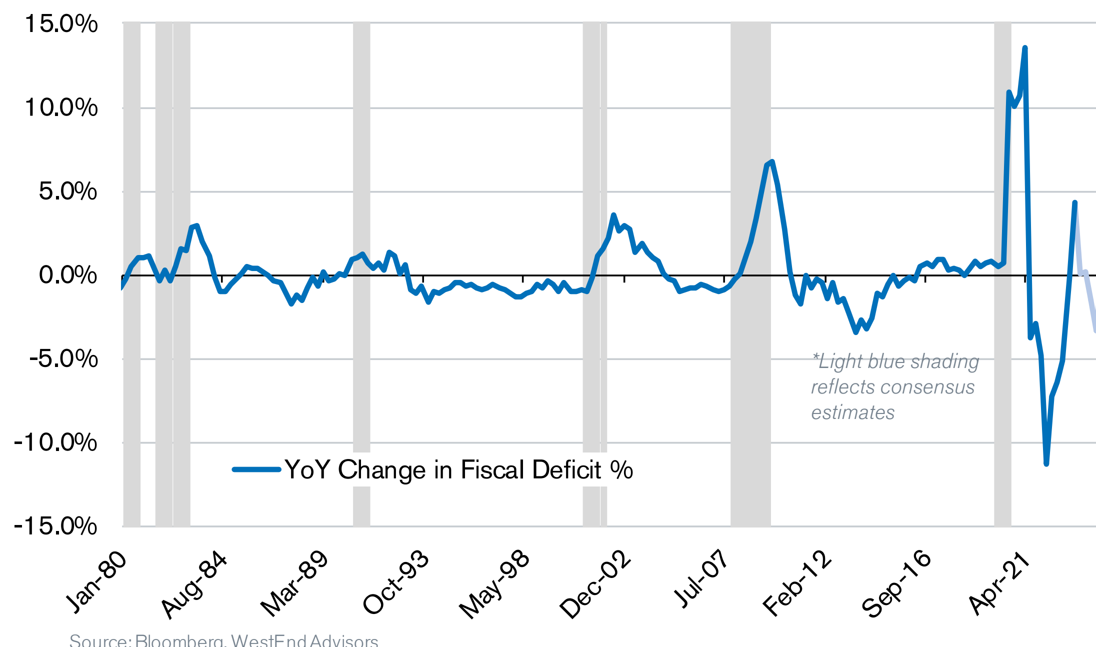
Portfolio Impact: Pauses in Federal Reserve tightening cycles **are a typical symptom of a late-stage environment and can last for several quarters.** While equities and bonds can post positive returns *during* a pause, this does not typically mark the beginning of a new cycle nor imply that economic growth is in the clear.

In the three most recent economic cycles, the **Federal Reserve paused its interest rate tightening cycle** during what proved to be the later stages of the cycle. In each instance, the **pause lasted between 6 and 12 months before the economy entered recession** and the rate cutting cycle began.

The U.S. economy has also experienced **periods of late-cycle disinflation** before (see bottom table). During these environments, the average length of **time from the core CPI peak to the start of a recession was 20 months** (16 months excluding the late 1960s outlier). Generally, **Health Care, Consumer Staples and Information Technology performed well.**

Fiscal Policy a Counterbalance to Monetary Tightening, but Trends Set to Normalize

FISCAL POLICY BOOST SET TO NORMALIZE



Source: Bloomberg, WestEnd Advisors

Portfolio Impact: Expansive fiscal policy is an unusual attribute of the current late-cycle backdrop that has likely tempered the impact of monetary tightening. That said, **the fiscal tailwind created by this policy is set to diminish** in the coming quarters which could leave the economy more exposed to the lagged impacts of Fed policy, in our view. **A healthy degree of defensive exposure is warranted given these dynamics.**

In Q2, the so-called "fiscal impulse" positively inflected to levels historically associated with government responses to recessions, driven by delayed income tax receipts, higher interest expense, and increased spending on Medicare and Social Security, among other items.

The recent expansion of the fiscal deficit has likely buttressed the U.S. economy in the face of the historic pace of monetary tightening, though we believe **the fiscal tailwind is set to diminish in the coming quarters as certain drivers of the recent expansion normalize**. Additionally, outlays associated with recently passed infrastructure-related legislation are expected to remain only a modest contributor to deficit expansion within our investment horizon.

Valuations and Earnings Expectations Pose Risks For 2024

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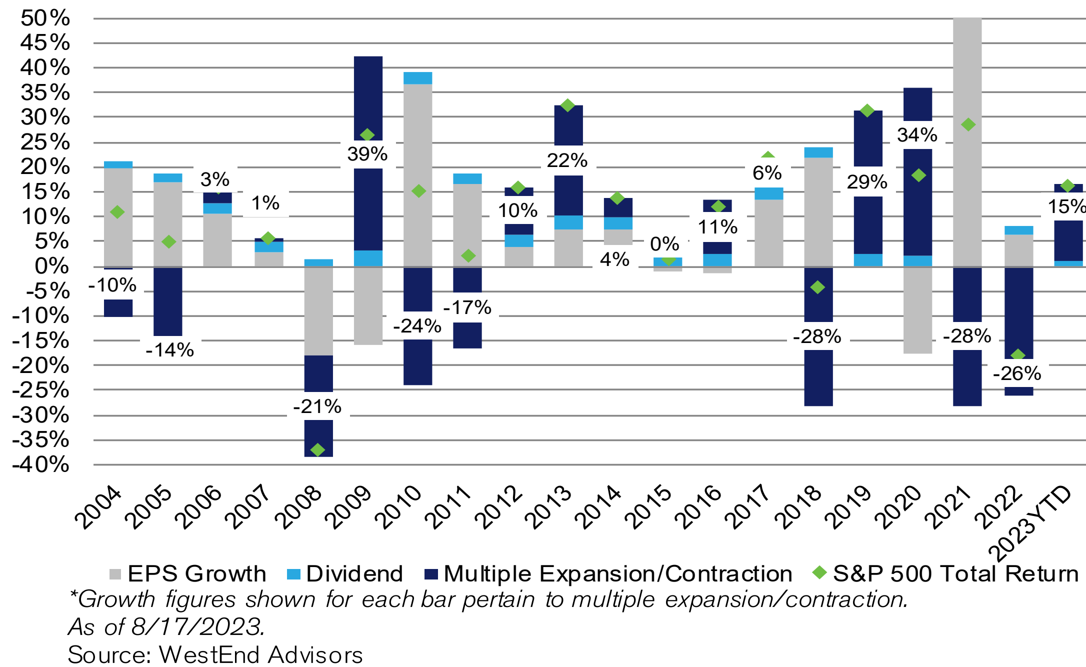
CONTRIBUTORS TO S&P 500 TOTAL RETURN



Growth figures shown for each bar pertain to multiple expansion/contraction.
As of 8/17/2023.
Source: WestEnd Advisors

Portfolio Impact: 2023's valuation expansion is unlikely to repeat in 2024, in our view, increasing the market's reliance on earnings growth to fuel further equity market gains at a time of heightened macro risk. As such, we are **avoiding parts of the U.S. market that we believe could see the greatest earnings headwinds** in the event of an economic slowdown, such as the **Energy, Materials, and Industrials sectors.**

The S&P 500 has delivered strong double-digit returns YTD against the backdrop of lackluster earnings growth. **As the chart above shows, multiples have expanded about 15% since the start of the year, effectively driving the entirety of this year's equity market advance.**

With an S&P 500 forward P/E multiple of approximately 19x , we believe the valuation expansion observed this year is unlikely to repeat in 2024, increasing the importance of earnings growth to propel the market higher from current levels. **Earnings, in our view, continue to be at risk over the next 6 to 12 months due to various economic factors including the lagged impact of monetary tightening.**

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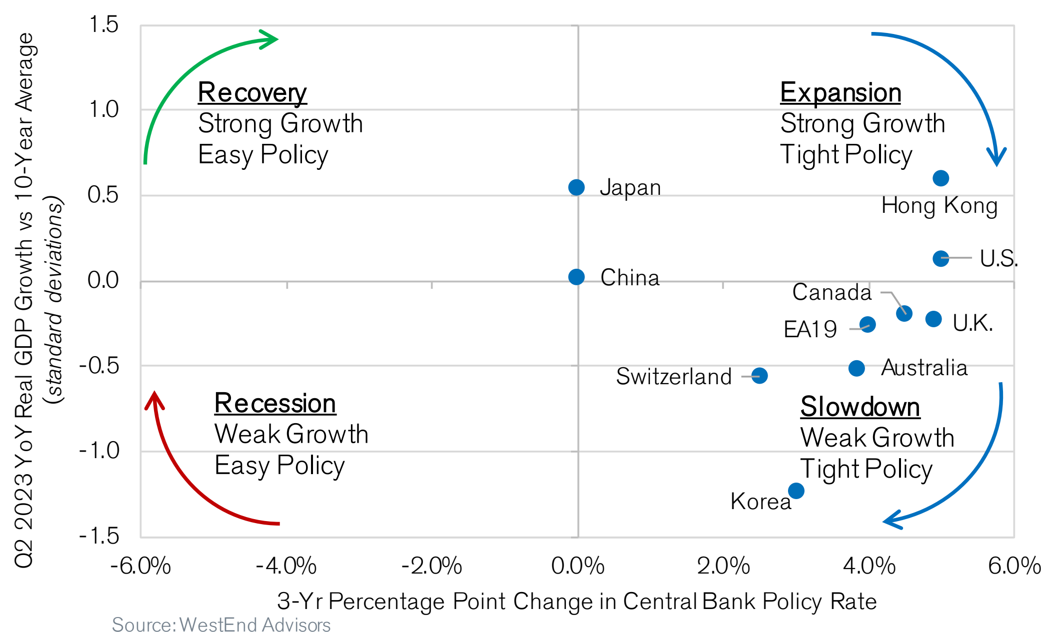
International Economic & Market Backdrop

Global Economy Remains in Slowdown Phase

GLOBAL ECONOMIC & POLICY CYCLE IN LATER INNINGS



Source: WestEnd Advisors

Portfolio Impact: The global economy is in the later stages of this economic cycle, in our view. Growth has moved below trend in most major economies, and the impact of the synchronized central bank tightening cycle is yet to be fully felt. We remain **overweight defensive regions globally, such as the U.S. and Japan.**

The U.S., the Eurozone, and the U.K. are all in the later stages of the economic cycle, in our view, amid **tight monetary conditions and still-elevated inflation**. Activity in the services sector has been resilient, but economic tailwinds (e.g., excess savings) continue to wane, and we believe **growth is at risk over next 6-18 months**.

In contrast, **Japan's economy is still transitioning from a Covid-19 recovery into a more normal expansion**, due to the gradual rebound from Covid-19 restrictions. We continue to see the potential for **healthy nominal growth,** as the BoJ has signaled it will **remain accommodative even with inflation modestly above target**.

In China, economic headwinds have kept growth well below average levels. The ongoing recovery in services activity has been largely offset by **soft export demand, the property sector downturn, consumer/business caution, and limited stimulus**.

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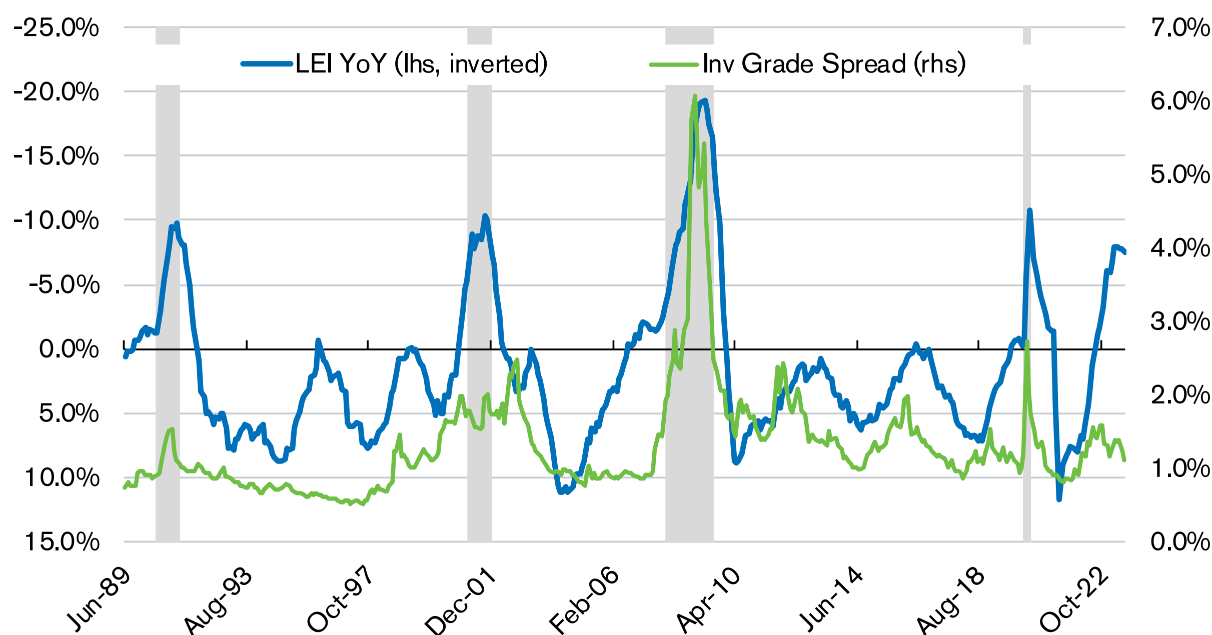
Interest Rates & Credit

Corporate Credit Pricey Amid Elevated Macro Risk

CREDIT NOT COMPENSATING FOR MACRO RISKS



Source: Bloomberg, WestEnd Advisors

Portfolio Impact: Credit spreads are below average levels of the last 30 years, yet **leading indicators continue to point to an elevated macro risk environment**. As such, we are maintaining an **underweight of corporate credit, and favoring long-duration Treasury securities** within our balanced portfolios.

Various measures of economic activity continue to point to slower growth and an elevated risk of recession, which, in our view, creates an **unattractive setup for corporate credit, given the below-average spread environment**. Higher interest costs instigated by Fed tightening, lower credit availability, and decelerating profit growth could portend a deterioration in credit fundamentals over the next 18 months, resulting in higher spreads and a subpar return environment for corporate bonds. **We prefer high quality Treasury exposure at this point in the cycle, with a bias towards long-duration maturities** which we expect should deliver returns that are comparatively more attractive against the backdrop of potential credit deterioration and slowing growth.

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Footnotes & Disclosures

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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.

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