WESTEND Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary
Q3 2023

Maintaining Balance Late in the Cycle

A mix of resilience in some economic measures and deterioration in others is typical in the later stages of a cycle. As ongoing slow growth faces headwinds, we believe balancing defensive exposures and moderate economic sensitivity is warranted.

SUMMARY

- While moderate growth continues in the U.S., late-cycle risks persist, and we see no likely catalyst for resumed dynamic growth.
- Most international markets face greater headwinds, in our view, than the U.S., though Japan appears to offer upside opportunity.
- We see a balance of defensive and economically sensitive exposures as appropriate given elevated economic uncertainty.

Q3 2023 REVIEW

After a continued run-up in July, equity markets reversed to finish Q3 2023 in negative territory, with the S&P 500 returning -3.27% for the quarter. The initial downturn was driven, in part, by declines in a number of large, high-valuation technology-related stocks. As the quarter progressed, an additional headwind for investor sentiment, in our view, was the Fed's shift in messaging to "higher for longer" on short-term interest rates, which pushed out expectations for the timing of eventual rate cuts. Longer-term interest rates rose in Q3, with the 10-year Treasury yield up 73 bps to end the quarter at 4.57%, its highest yield since before the 2008 financial crisis. While inflation has eased significantly this year, core inflation remains well above the Fed's 2% target, with core PCE inflation still at 3.9% year-over-year. Services inflation excluding shelter (which is even higher but starting to ease) has been stuck in a range of roughly 4%-5% year-over-year since early 2021. These readings suggest it may take a while for the Fed to reach its target.

In the U.S., measures of economic activity remained mixed. Aggregate consumer income and spending growth, as well as headline employment gains, remained in solid-but-below-average territory, while other indicators suggested weakness. For example, the Leading Economic Index continued to decline on a year-over-year and six-month basis, the Bureau of Economic Analysis' various measures of corporate profits across the entire economy appear to have stalled or even peaked, and existing home sales in July and August were below the trough reached at the height of the pandemic shutdowns. Concerns over a potential U.S. government shutdown may have also been a modest headwind for the broad market late in the quarter, though markets have historically looked past such issues fairly quickly.

Sector performance in the U.S., like economic data, was mixed. Energy and Communication Services were the only sectors with positive returns, but Financials and Health Care also outperformed. Real Estate and Utilities were the worst-performing sectors, likely reflecting, in part, the rise in interest rates during the quarter.

International equity markets performed roughly in line with the U.S. Economic activity in Europe and China remained subdued. Japanese data was more favorable, as it posted expansionary GDP growth amid moderately elevated inflation, and the BoJ remained accommodative.

Fixed income markets also posted negative returns in Q3, as the impact from rising interest rates offset the benefits of elevated yields for investment grade bonds.

OUTLOOK

Late-Cycle Conditions
Areas of economic resilience and deterioration are normal, in our view, late in the economic cycle.

Our broad view of the macroeconomic and market backdrop remains largely consistent with earlier in the year, which we believe warrants a balance of exposures to defensive areas of the market and areas that should benefit if growth persists. Real U.S. GDP growth in the first half of the year, while moderate, did exceed expectations, and some metrics like personal consumption and labor productivity have improved in recent months. Resilience in some areas of the economy may have pushed out the near-term risk of recession somewhat, but multiple indicators still signal heightened risks for the economy. All of this is consistent with a late-cycle environment.

We continue to see significant risks to growth in the U.S., ranging from the rise in interest rates to a stall in, and possible rollover of, broad measures of corporate profitability. Weakness in key areas of the labor market that tend to lead broader employment trends also suggest that job growth is at risk. Crucially, even if the Fed succeeds in engineering a so-called "soft landing," we still see little fuel for a sustained reacceleration of economic activity in the near-to-intermediate term.

Underweighting International
We generally see weaker economic conditions abroad than at home, though Japan remains a bright spot.

We generally see weaker conditions outside the U.S. Europe faces ongoing inflation and tight monetary policy, China continues to struggle with growth amid its post-lockdown reopening, and slow global growth does not bode well for economically sensitive emerging markets in general. Japan remains an international bright spot, with expansionary GDP growth, moderate inflation, and accommodative monetary policy.

U.S.: Consumers have remained resilient so far this year, with respectable income and spending growth, but we see various risks to both income and spending ahead. For example, the resumption of student loan payments threatens to eat into many consumers' spending power, just as savings cushions that were accumulated during the pandemic are nearly depleted and oil prices are rising again.

We still believe the worst impacts of the sharp rise in interest rates precipitated by the Fed, tight lending standards, and a rollover in corporate profits have yet to be fully felt. The Fed's tight monetary policy in particular has tendrils that reach into nearly every area of the economy. The housing market has clearly already suffered as mortgage rates have risen to 20-year highs. Separately, with easing inflation, real interest rates have recently risen to decade-long highs. This can raise hurdle rates for corporate investment in fixed assets and other initiatives, as financing costs are less likely to be recouped by inflation over time. We are seeing an apparent boost to high-tech manufacturing investment tied to the 2022 CHIPS Act, but this is limited in scope compared to larger headwinds we see for corporate investment. Additionally, rising government interest expense, while still low historically, may reduce flexibility for more productive government spending, particularly in a polarized political environment.

Some other factors, including the narrowly avoided government shutdown and ongoing strikes by actors and autoworkers can present risks to near-term economic activity and for market volatility. Such events are generally short-term in nature, however, and we believe the market often looks past them. These are not factors that tend to have a material impact within our normal six to 18-month investment horizon. With that said, we do consider the potential longer-term impacts of such events, like the risk for ratings agency downgrades on government debt or upward pressure on wages.

Given the mix of evidence we see for continued moderate growth and late-cycle risks, we are currently allocating about half of our domestic equity exposure to the late-phase, defensive Health Care, Consumer Staples, and Utilities sectors, and about half to mid-phase sectors with moderate economic sensitivity, specifically Consumer Discretionary, Communication Services, and Information Technology. While valuations in these sectors may remain elevated, we believe that secular earnings growth drivers, recent valuation contraction, and a low likelihood of continued significant interest rate increases all help mitigate valuation risk going forward. We are largely avoiding other more cyclical sectors, where we still see the most risk to earnings, such as Energy, Materials, and Financials.

International: In global portfolios, we are underweight international equities overall, including Europe, given its ongoing headwinds, and emerging markets (EM), which tend to be more economically sensitive than developed markets. We continue to overweight developed Asia, including Japan, which has a relatively attractive economic backdrop.

The Eurozone has posted very modest GDP growth so far this year but has little fuel for strong recovery. Europe still faces greater inflation risk than the U.S., in our view; its monetary and fiscal tightening continue; and it has less of a savings cushion than the U.S. Further, about half of Europe's equity market capitalization is from early-phase, economically sensitive sectors like Financials, Industrials, and Energy.

Some EM economies are likely helped by a recent uptick in commodity prices, but sustained economic reacceleration for EM is unlikely, in our view, given slow growth globally. China's reopening has benefitted some internally facing areas of its economy, like retail trade, but weak global demand, challenges in the property market, and geopolitical factors present ongoing risks for its export-focused economy.

Within our one international overweight, developed Asia, we see Japan's economy rebounding. With stimulative monetary and fiscal policies in place and relatively moderate inflation, Japan has recently posted its second-highest nominal GDP growth in three decades. We believe this should support strong earnings growth for Japanese firms.

Not "Higher Forever"
As the Fed approaches a likely end to rate hikes, we see limited upside risk and potential for downside to longer-term interest rates within our investment horizon.

Fixed income and other assets: In traditional balanced portfolios, we see the risk/reward profile of fixed income as attractive relative to equities. We maintain an overweight of fixed income with an emphasis on Treasury and longer-duration exposures. We see risks to corporate spreads, but elevated Treasury yields, in our view, provide both a source of return and some cushion if rates move up further.

For portfolios with greater asset class flexibility, we also see diversification and appreciation potential in gold and select energy infrastructure exposure. Our analysis indicates that gold tends to perform well in periods of elevated inflation as well as periods of economic deterioration or recession, and we see income from energy infrastructure assets as an attractive complement to bond exposure.

CONCLUSION

In view of the late-cycle mix of growth and risks we see, we believe it is appropriate to allocate to areas of the market that offer a balance of defensive positioning and moderate economic sensitivity. At the same time, we are avoiding or underweighting those areas of the market that might be most negatively impacted by an economic downturn. Of course, as always, we stand ready to adjust portfolio positioning as our outlook evolves.

WestEnd Advisors Investment Team | October 2, 2023

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