WESTEND
Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

# Macroeconomic Highlights

## Q4 2023

20231002-3145416

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# WestEnd Outlook Highlights

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- Our broad view of the macroeconomic and market backdrop remains largely consistent with earlier in the year. 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, which we believe warrants a balance of exposures to defensive areas of the market and areas that should benefit if growth persists. We see the most risk to earnings for more economically sensitive sectors, but we see opportunity in select U.S. equity sectors and fixed income.
  - We believe the lagged impacts of various factors—including the sharpest set of Fed rate hikes since the 1980's, tighter bank lending standards, and rapidly decelerating corporate profits growth—have yet to be fully felt and pose material headwinds to the economy in coming quarters.
  - 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, including the resumption of student loan payments and depletion of savings cushions that built up during the pandemic.
  - We believe long-term U.S. interest rates could decline in coming quarters, as the Fed could reach its peak target Fed Funds rate for this hiking cycle by December and as economic growth and inflation slow.
- Internationally, we generally see weaker conditions than in 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 presents a headwind for economically sensitivity emerging markets. Japan remains an international bright spot, with expansionary GDP growth, moderate inflation, and accommodative monetary policy.
- We continue to position portfolios for the later stages of the economic cycle and in view of current risks and opportunities:
  - In U.S. large-cap equity allocations:
    - We are avoiding early-phase cyclical U.S. sectors in all our strategies.
    - We are emphasizing mid- and late-phase sectors that we expect will see less deceleration in earnings as economic growth slows, including overweights of Communication Services, 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 traditional balanced portfolios:
    - Seeing reduced risk to fixed income returns and late economic cycle risks to equities, we maintain an overweight of fixed income.
    - Within fixed income allocations, we are emphasizing intermediate and longer-term securities that should benefit from declining interest rates, and we have moved to an overweight of Treasury exposure, which we believe could benefit amid a flight to perceived safe assets.

# 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

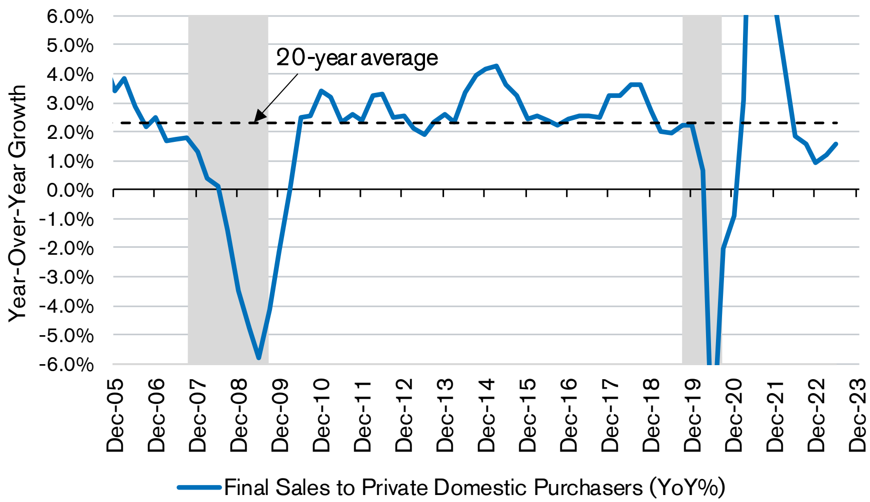
- Energy
- Financials
- Industrials
- Materials
- Real Estate

* For illustrative purposes only. Allocation information as of September 30, 2023. Source: WestEnd Advisors.

# U.S. Economic & Market Backdrop

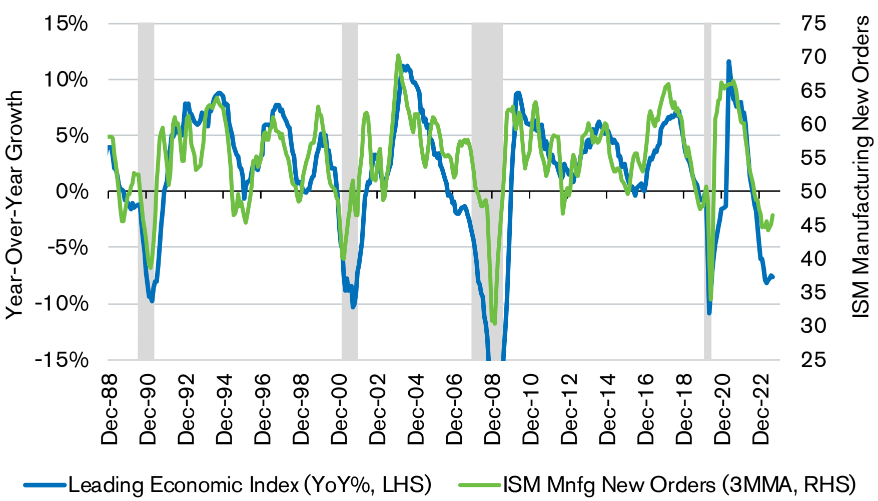
# Slow Economic Growth Brings Challenges

**DEMAND GROWTH SOFT BUT RESILIENT IN 2023…**




Source: BEA, WestEnd Advisors

**…WHILE LEADING INDICATORS ARE DOWN BUT HAVE STABILIZED**




Source: WestEnd Advisors

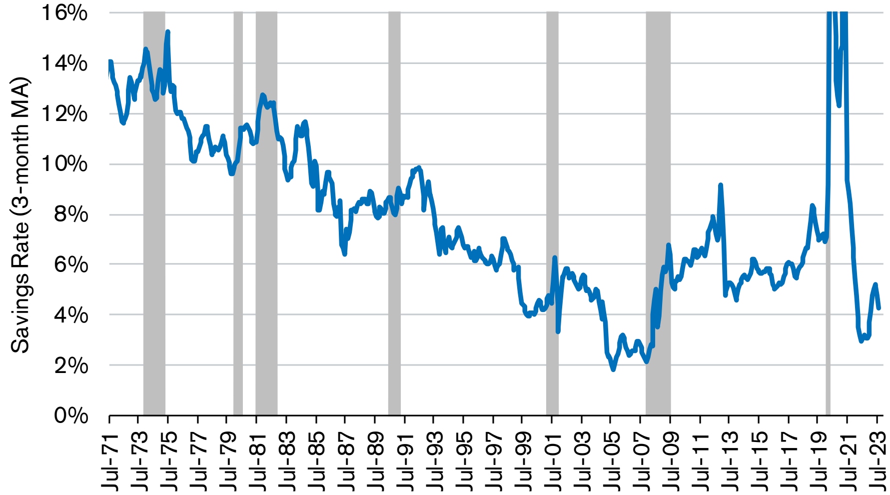
**Portfolio Impact:** Ongoing risks to the economy and profits in the U.S. warrant an emphasis of defensive sectors like **Health Care, Utilities, and Consumer Staples**, in our view. At the same time, the recent stabilization in activity supports allocations to more economically sensitive sectors like **Information Technology and Communication Services**.

A review of private domestic demand (top chart) shows that **growth picked up slightly in the first two quarters of 2023, despite remaining below the long-term trend.** Resilient consumer spending, in part driven by excess savings, as well as pockets of strength in certain investment categories, like manufacturing construction, have supported overall economic activity.

Similarly, the Leading Economic Index (LEI) and the new orders component of ISM Manufacturing have stabilized in recent months, though they remain at-or-below recessionary thresholds. Looking forward, we believe the prospect of economic retrenchment remains elevated, **which could put the earnings of the *most* economically sensitive sectors at risk**, but we remain constructive on mid-phase sectors that should benefit from continued growth.

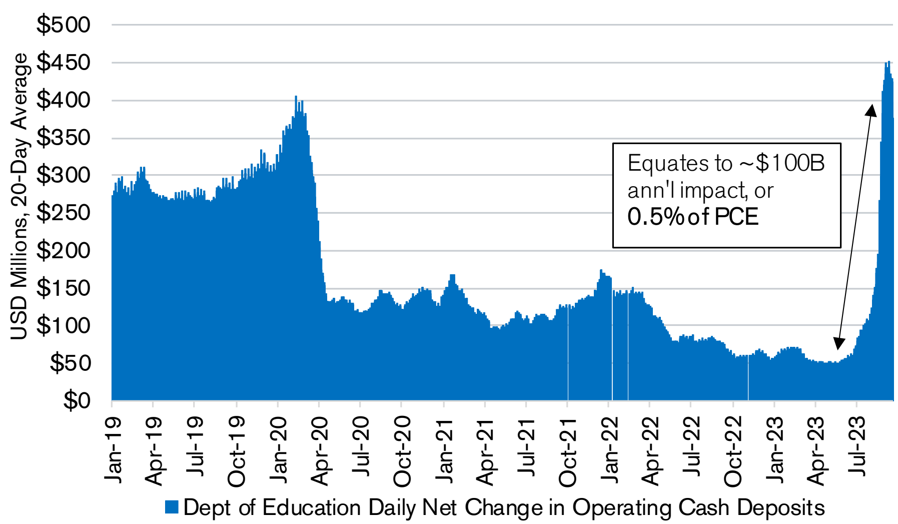
# Consumer Spending Growth Unlikely to Accelerate

### FURTHER SAVINGS RATE DECLINES UNLIKELY FROM HERE




Source: Bureau of Economic Analysis, WestEnd Advisors

### STUDENT LOAN PAYMENTS ARE RAMPING UP




Source: US Treasury, WestEnd Advisors

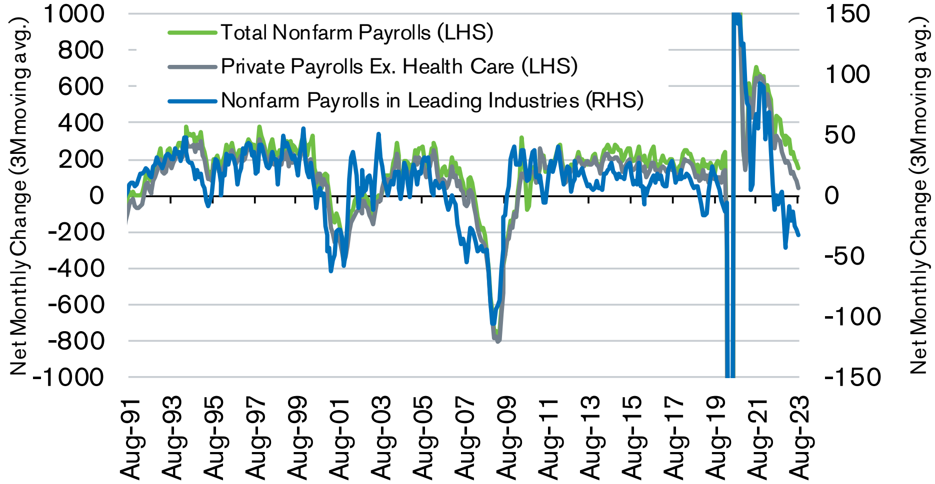
**Portfolio Impact:** The U.S. consumer has benefited in recent quarters from elevated savings during COVID. With excess savings diminishing, interest costs rising, and student loan payments restarting, **consumers are likely to have less spending fuel going forward**. A more challenged U.S. consumer could **increase risks to the U.S. economy**, in our view.

The rapid decline in the household savings rate was a key driver of robust personal consumption growth over the past two years. With the **savings rate now near the low end of its historical range**, households' ability to finance consumption via savings has largely evaporated.

Looking ahead, consumers face a growing number of headwinds, **including higher gas prices, rising interest costs, and the restart of student loan payments**, which alone could equate to a ~0.5% drag on nominal PCE (bottom chart).

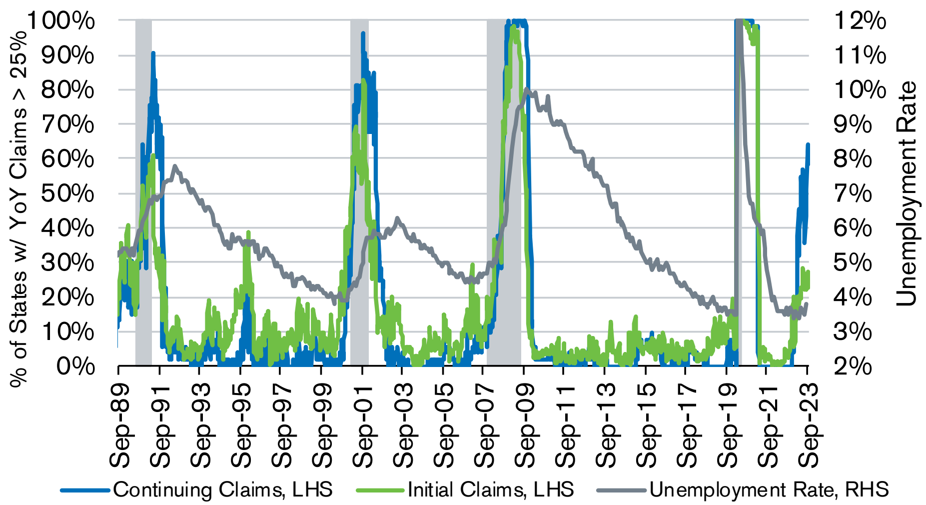
# Leading Labor Market Data Starting to Deteriorate

## PAYROLL GROWTH SLOWING RAPIDLY




Source: WestEnd Advisors, BLS; Covid extremes cut from chart

## CLAIMS POINT TO WEAKENING LABOR MARKET




Source: BLS, WestEnd Advisors

**Portfolio Impact:** Job growth has been 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.

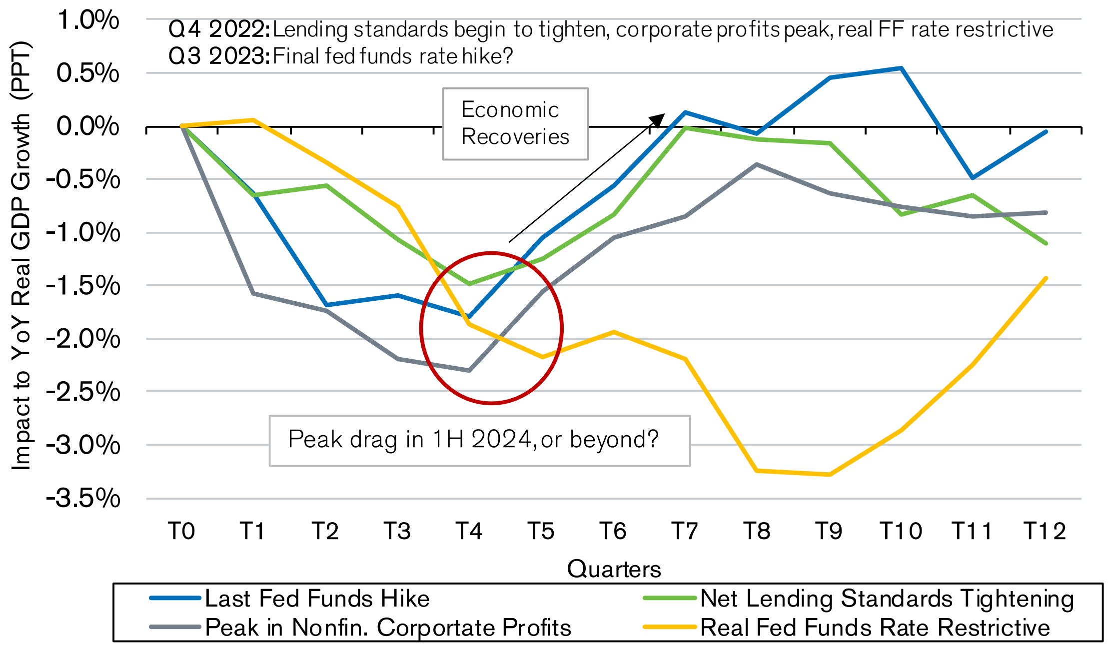
While total nonfarm payroll growth – a historically *lagging* indicator – remains healthy, **signs of incremental softening in the job market have started to show up in *leading* payrolls categories**.

Similarly, the **number of states with significant increases in reported claims is nearing levels associated with rising unemployment**. While the absolute levels of initial and continuing claims remain low, looking under the surface points toward a more mixed picture.

# Late-Cycle Forces Should Continue to Impact the Economy



### HISTORICAL REAL GDP GROWTH RESPONSE TO...




Source: WestEnd Advisors

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

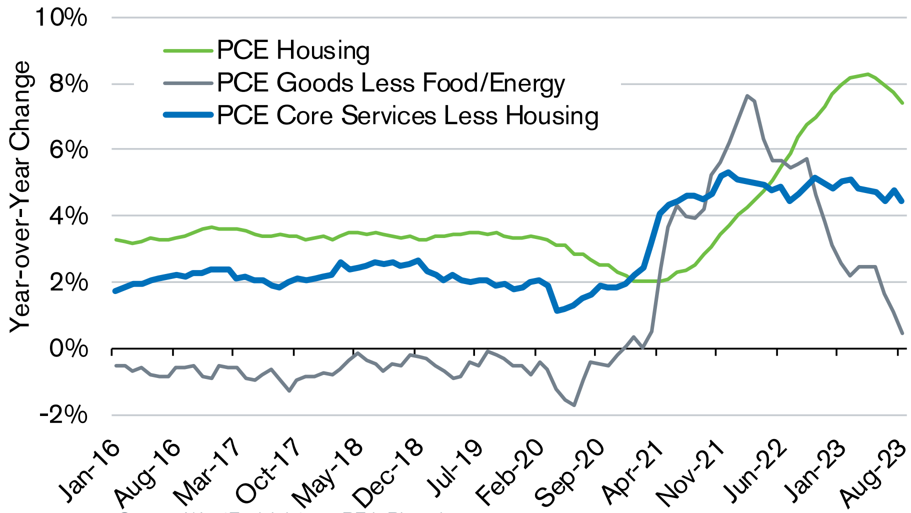
There have been several macroeconomic shifts over the past year that have *yet to fully reverberate through the economy*, including: 1) **The fastest monetary tightening cycle since the 1980's;** 2) **a significant increase in the percentage of commercial banks tightening C&I lending standards;** and 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, 3) a *peak* in the level of nominal non-financial corporate profits, and 4) the *first* quarter in which the real federal funds rate becomes restrictive (based on estimates).

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

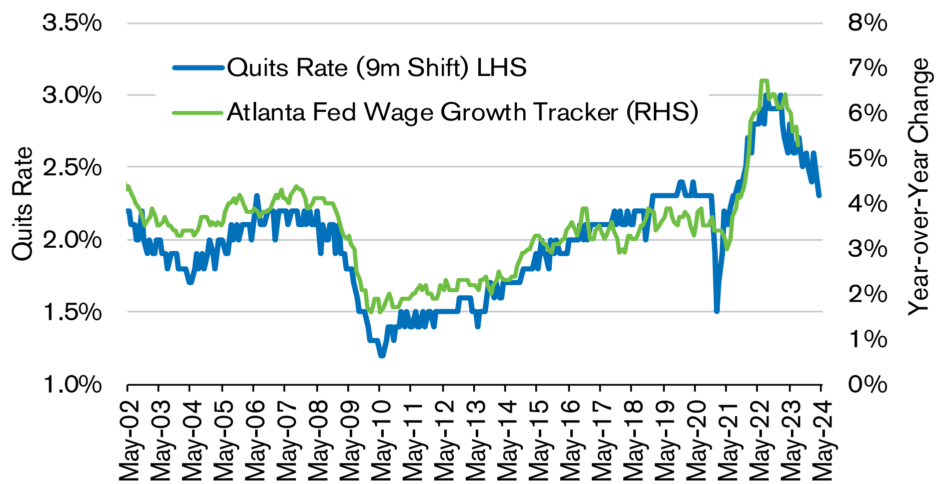
# Federal Reserve May Have More Flexibility in 2024

### WORK REMAINS TO BE DONE ON SERVICES INFLATION…




Source: WestEnd Advisors, BEA, Bloomberg

### … BUT SLOWING WAGE GROWTH SIGNALS PROGRESS




Source: WestEnd Advisors, Atlanta Fed, BLS

**Portfolio Impact:** Periods of **disinflation** have **historically benefited mid- and late-phase sectors**. Slow growth and disinflation are catalysts for lower rates, in our view, which supports relative opportunity in sectors like **Health Care, Consumer Staples, and Information Technology.**

Progress on services inflation remains slow, but we see core PCE continuing to decelerate into 2024. Services inflation stickiness may make the Fed wary of pre-emptively cutting rates, but signs of a more balanced labor market, including decelerating wage growth, may give the central bank more confidence that services disinflation is in the pipeline.

With signs of the labor market softening, including a lower quits rate and lower job openings, and the significant progress made on inflation, **we see the Fed as having more flexibility to manage policy rates over the course of 2024**. The Fed's stance of **weighing restrictive policy against slowing labor markets warrants both mid- and late-phase sector** allocations, in our view.

# Key '23 Growth Drivers to Reverse in Quarters Ahead

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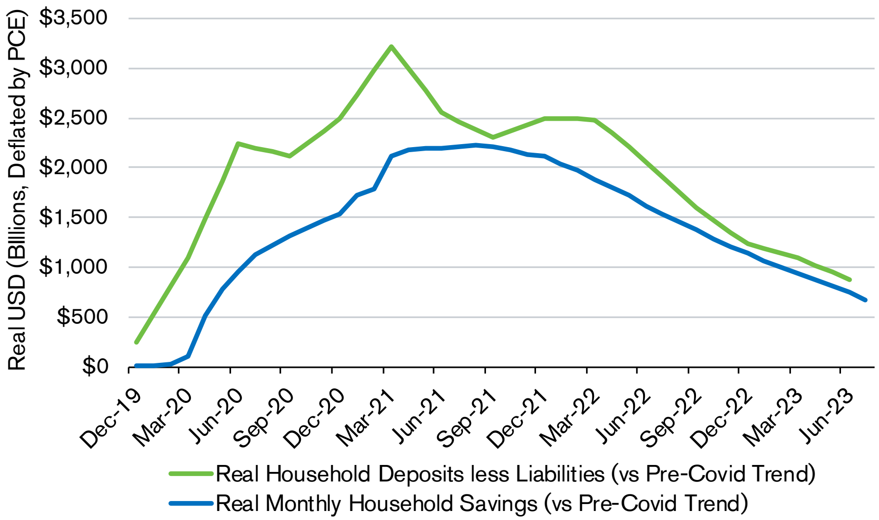
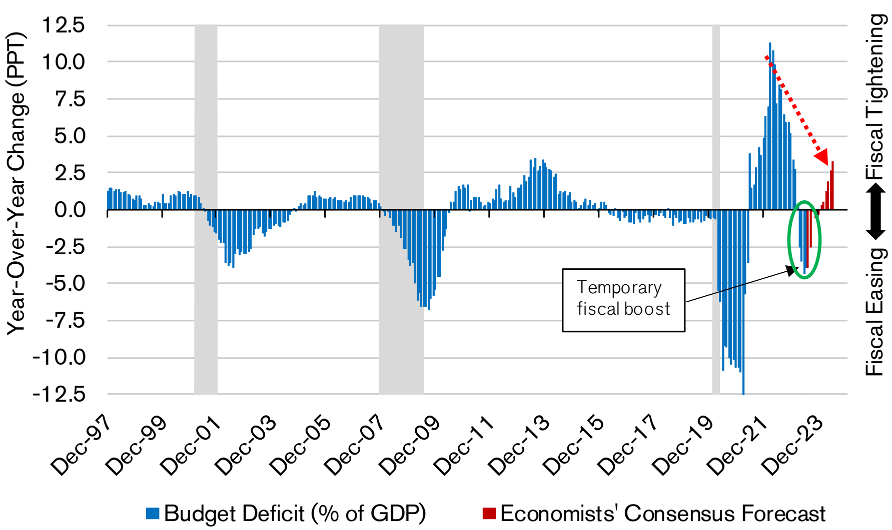
### PANDEMIC ERA SAVINGS BUFFERS ARE NEARLY DEPLETED




Source: BEA, Federal Reserve, WestEnd Advisors

### FISCAL SUPPORT TO PROVE TEMPORARY




Source: US Treasury, Bloomberg, WestEnd Advisors

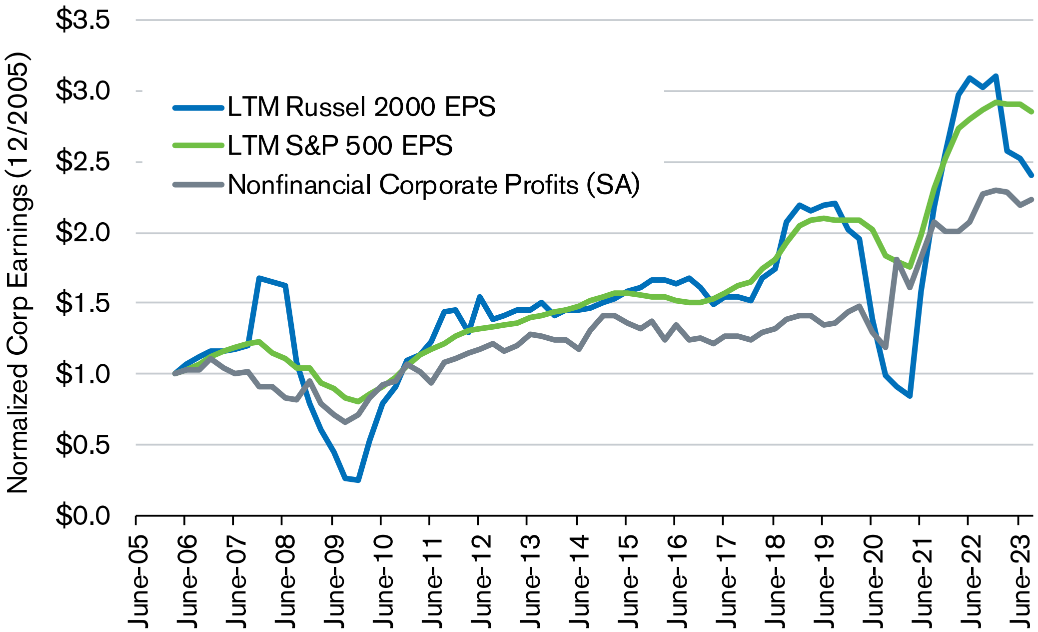
**Portfolio Impact:** Many of **the factors that supported economic growth in the first half of 2023 are likely to prove temporary**, in our view. As such, we **continue to limit cyclical exposures** across our portfolios, and remain underweight equities relative to fixed income in traditional balanced portfolios.

Economic growth has been supported by a number of factors in 2023 that we believe are unsustainable, including the run-down of excess savings by households, a wave of manufacturing and infrastructure construction starts, elevated deficit spending, and (up until recently) low *real* interest rates.

Looking forward, we expect many of these **growth drivers to dissipate in the coming quarters**. Measures of excess savings are falling rapidly and are likely to be depleted by the end of the year (top chart). The fiscal deficit is likely to narrow over the next year (bottom chart) due to higher tax revenues and smaller increases in health care spending and income support programs.

# Earnings Headwinds Exist Beyond the Largest Public Companies

### CORPORATE EARNINGS HAVE STALLED OR WORSE




Source: WestEnd Advisors

**Portfolio Impact:** The BEA's measure of corporate profits signals earnings growth has stalled. S&P 500 EPS growth is likely to remain subdued, in our view. As such, we are largely **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 Financials sectors**.

Trailing-twelve-months earnings for the S&P 500 and Russell 2000 are down from their recent highs, with small-caps down much more sharply (-18% YoY). The Bureau of Economic Analysis has another measure of **Nonfinancial Corporate Profits, which excludes earnings by the Federal Reserve, which are off their peak too, and are little changed over the last two years**. It is important to follow the BEA's measure of corporate profits, in our view, as it gives a broader assessment of corporate earnings, which has implications for investment and small business employment, the largest segment of labor market.

S&P 500 earnings are expected to recover next year, led by mega-cap technology companies. Those rebounds should benefit profits in those sectors, but we are skeptical of a broad-based earnings recovery and a related acceleration in economic activity.

# Fed Pause Consistent with Late-Cycle Conditions

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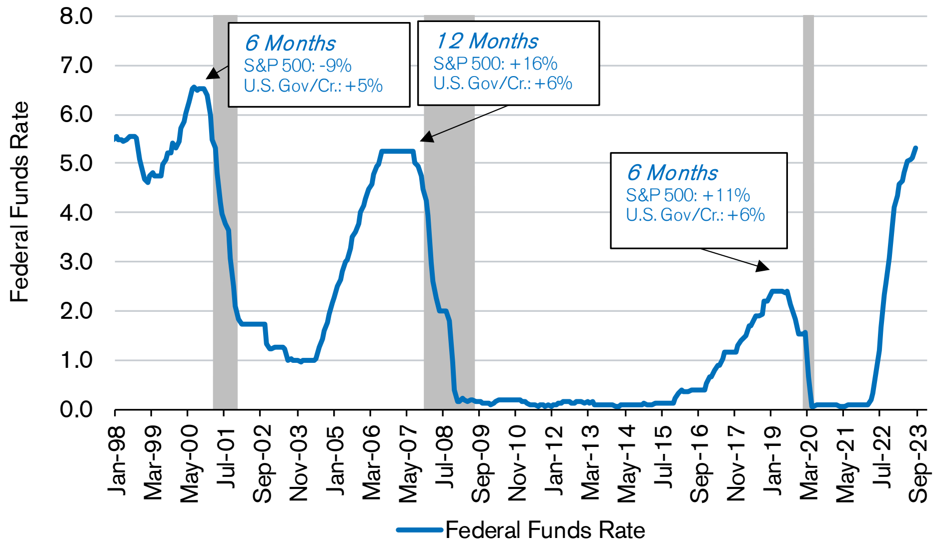
## LATE CYCLE ENVIRONMENTS CAN VARY IN LENGTH




Source: WestEnd Advisors

| 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, we believe this does not 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 cutting cycle began.

The U.S. economy has also experienced **late-cycle periods of 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.**



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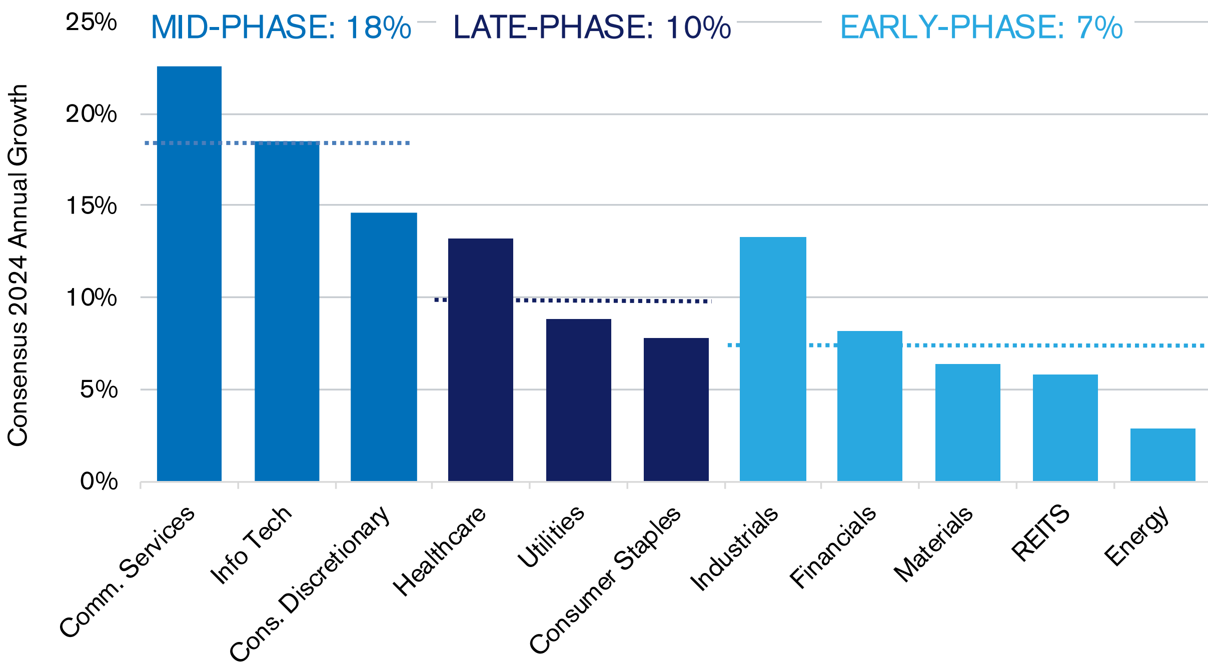
# Sector Earnings Growth Outlook for 2024

### 2024 EPS GROWTH ESTIMATES




Source: WestEnd Advisors

**Portfolio Impact:** The consensus estimate is for S&P 500 earnings growth to resume in 2024. We are skeptical of the estimated magnitude of the market's earnings rebound, but **we have more confidence in the expected strength of mid-phase and late-phase sector earnings, led by the Communications Services and Health Care sectors, respectively**.

**Mid-phase and late-phase S&P 500 sectors are expected to achieve above-average earnings growth** in 2024 relative to their historical growth. Given the challenges we see to economic growth in the period ahead, we see risks to the overall recovery in 2024 S&P 500 earnings. That said, **we have greater confidence that the late-phase sectors can come closer to achieving analysts' growth expectations for next year, given those sectors' history of less economic sensitivity and earnings variability**. That outlook contrasts with early-phase sectors, for which economic headwinds could result in significant earnings shortfalls, on what is already the weakest average growth among the three sector groupings.

# U.S. Sector Outlook

# Late-Phase Sectors Provide Steady Earnings

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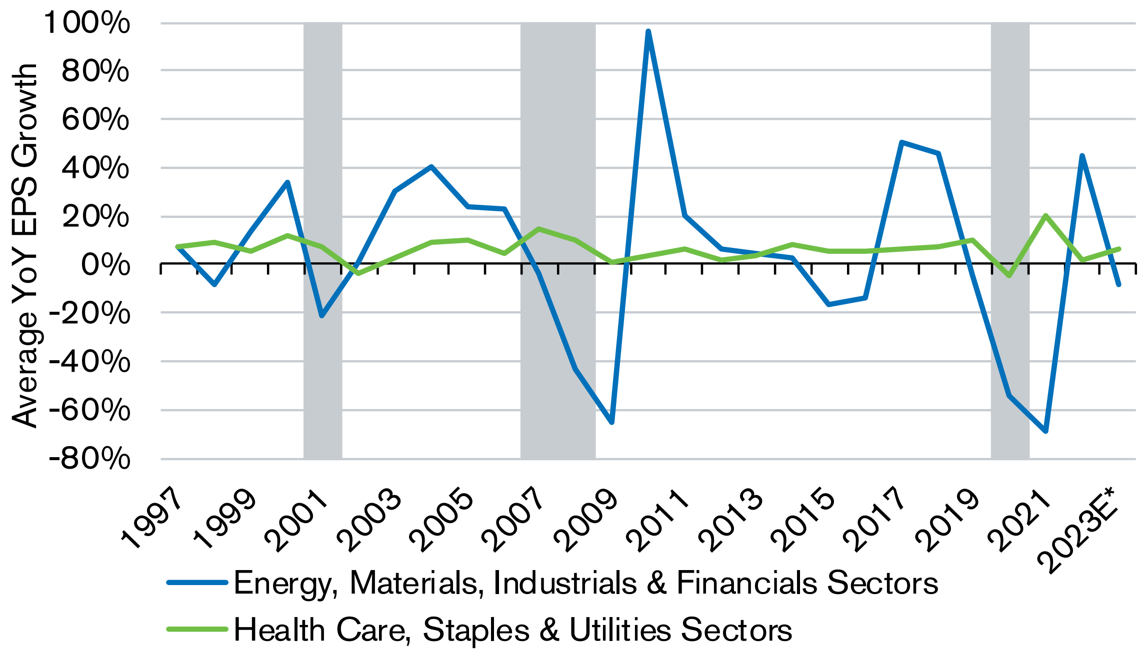
## EARNINGS GROWTH BY SECTOR




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 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 as **the economic cycle matures and the risk of a slowdown in economic growth increases**.

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

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

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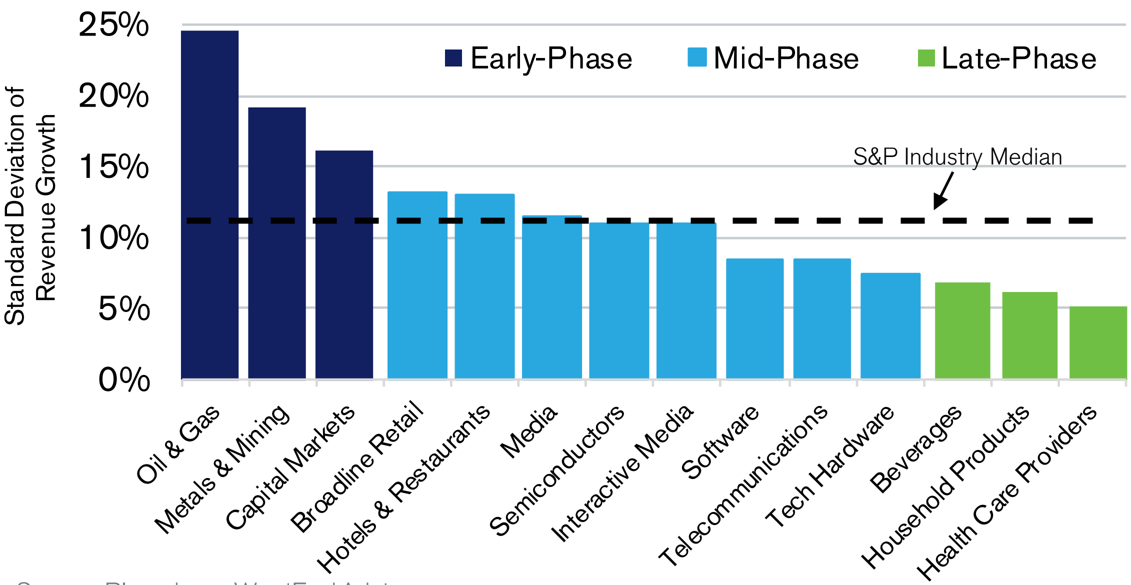
## SELECT INDUSTRY REVENUE VOLATILITY




Source: Bloomberg, 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, more economically sensitive areas of the market** due to strong secular growth trends benefitting these sectors. As a result, we continue to **maintain allocations to Information Technology and Communication Services**.

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, chips to support AI, 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.**

# Mid-Phase Sectors Should Benefit From Profitability and Less Pressure on Valuations

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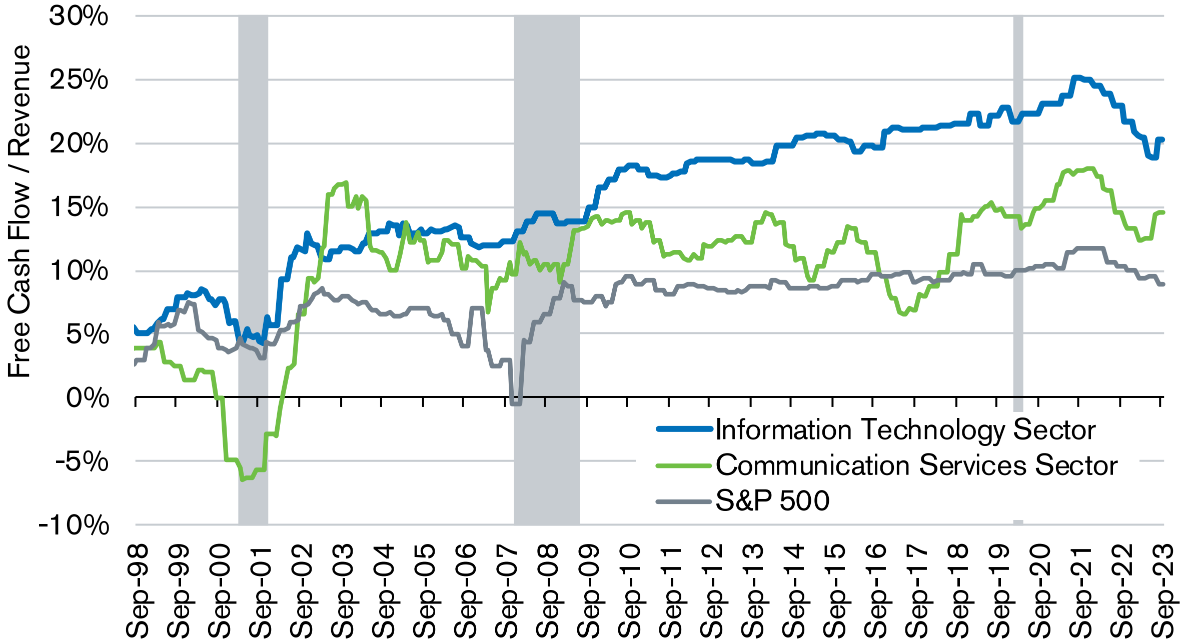
## MID-PHASE SECTORS EXHIBIT STRONG PROFITABILITY




Source: WestEnd Advisors, Bloomberg

**Portfolio Impact:** As economic growth continues to slow, we believe **Information Technology and Communication Services can maintain profitability due to the muted cyclicality of technology business investment and high margins.** These quality attributes are favorable in the latter stages of the economic cycle, in our view.

The quality and profitability of the Information Technology and Communication Services sectors can be seen in the sectors' above-market conversion of sales into free cash flow.

These quality attributes should benefit the fundamentals of Tech and Communication Services companies, while **fewer Fed rate hikes over the next year and an outlook for strong above-market EPS growth should produce less downward pressure on mid-phase valuations**.

# Financials Face Challenges in Late-Cycle Environment

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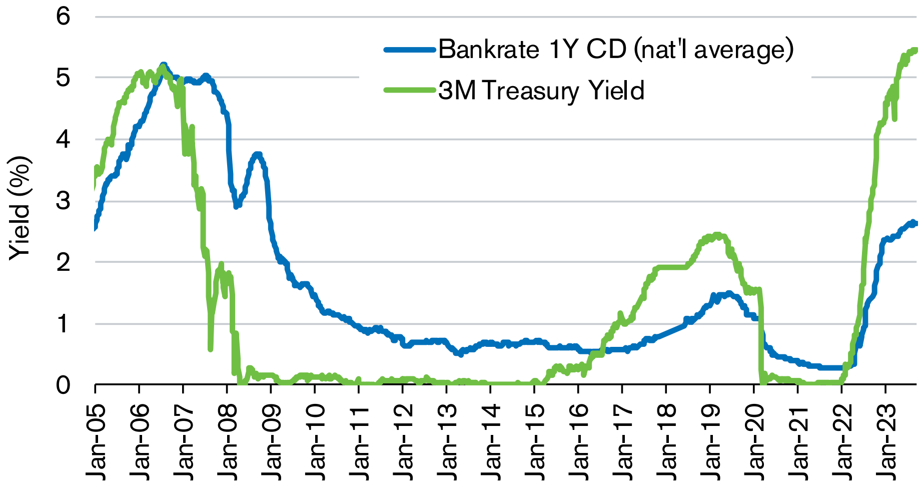
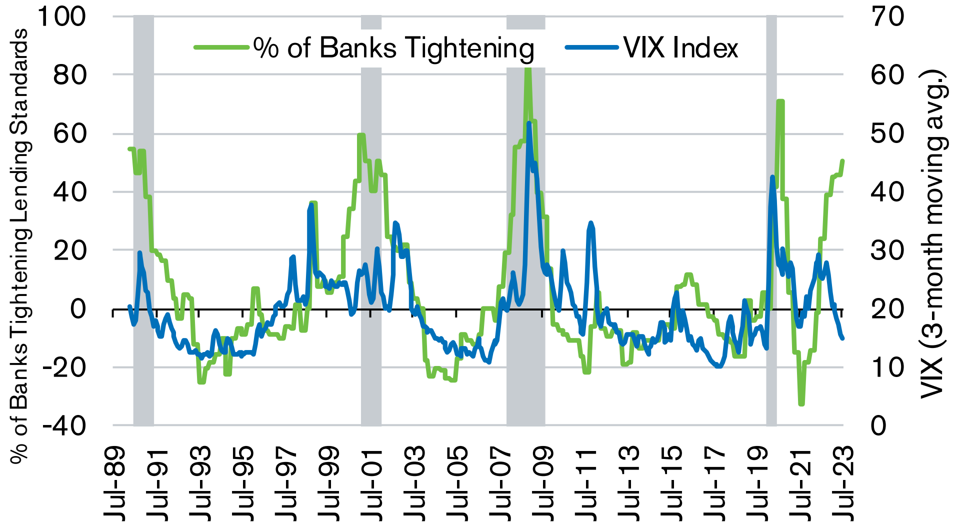
**COMPETITION FOR BANK DEPOSITS INCREASES**




Source: Bloomberg, WestEnd Advisors

**CREDIT AND CAPITAL MARKETS REFLECT LATE-CYCLE, NOT CRISIS**




Source: WestEnd Advisors, Federal Reserve, Bloomberg

**Portfolio Impact:** We are generally **avoiding the Financials sector** in portfolios, as we believe the prospects of net interest margin pressure, slower loan growth, and the building of loan loss reserves increase the likelihood of a deterioration in the earnings outlook for the sector.

Bank failures in Q1 put the spotlight on a normal late-cycle challenge for banks as short-term interest rates increase. Depositors now have higher-yielding alternatives for their funds. Now, **banks not only need to increase interest paid on deposits, but also likely face additional regulatory pressure and costs** in the wake of highly visible bank collapses.

As the economy enters the latter stages of the economic cycle, banks are tightening credit standards. **We expect banks to build reserves** for potential loan losses as they have done in the past, which creates a headwind for bank earnings. Tighter credit conditions have historically been associated with market uncertainty. Market volatility and tighter credit are both **headwinds to capital markets activity**. Collectively, banks and capital markets firms make up roughly half of the Financials sector by market capitalization.

# Expect Energy Sector Fundamentals to Soften

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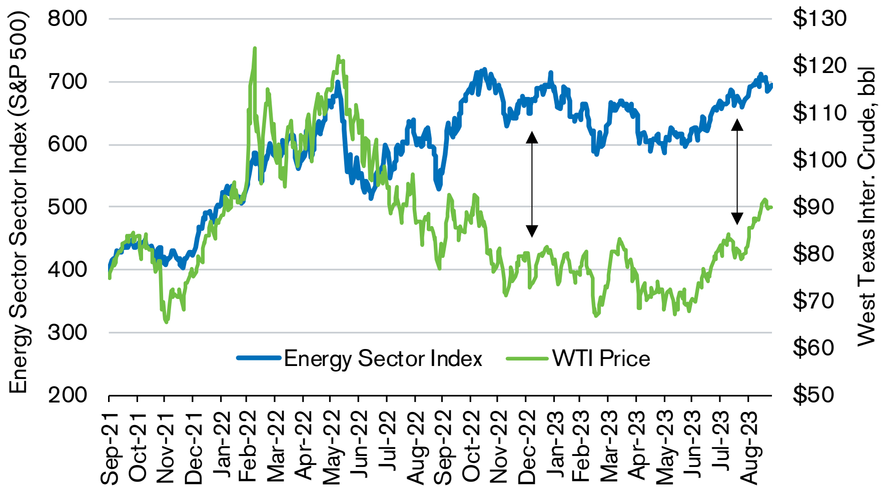
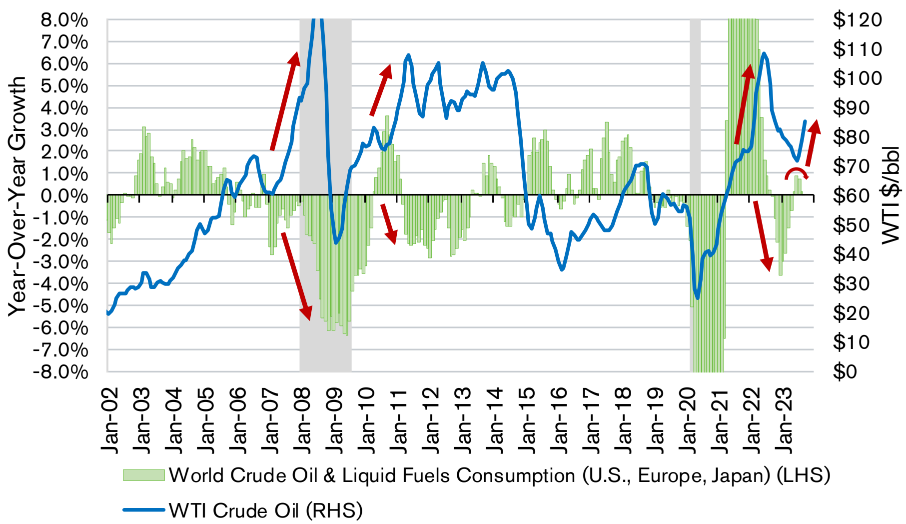
### ENERGY SECTOR INDEX VS. CRUDE OIL PRICE




Source: WestEnd Advisors, Bloomberg

### OIL ABOVE $90 WEIGHS ON DEMAND GROWTH




Source: BEA, WestEnd Advisors

**Portfolio Impact:** We continue to **avoid Energy sector exposure** in portfolios, as we believe the prospect of slower growth in the U.S. and abroad, coupled with the **potential for significant margin compression**, increases the likelihood of a deterioration in the earnings outlook for the sector.

The global energy commodity complex has moved higher in recent months on the back of OPEC+ supply cuts and China's re-opening. Still, the outlook for the U.S. Energy equity sector remains challenged, in our view.

**The top chart shows that the divergence in the price of crude oil (WTI) and the S&P 500 Energy sector remains wide.** Unusually elevated refining margins have propped up sector earnings, despite oil price growth remaining negative on a year-over-year basis. Historically, Energy's relative performance has peaked alongside oil prices, and **refining capacity is set to rise in 2024**.

As the economy enters the latter stages of this cycle, we believe oil and gas demand growth is set to decelerate, as **oil prices in excess of $90 have consistently led to demand destruction in** developed economies over the past two decades (bottom chart).

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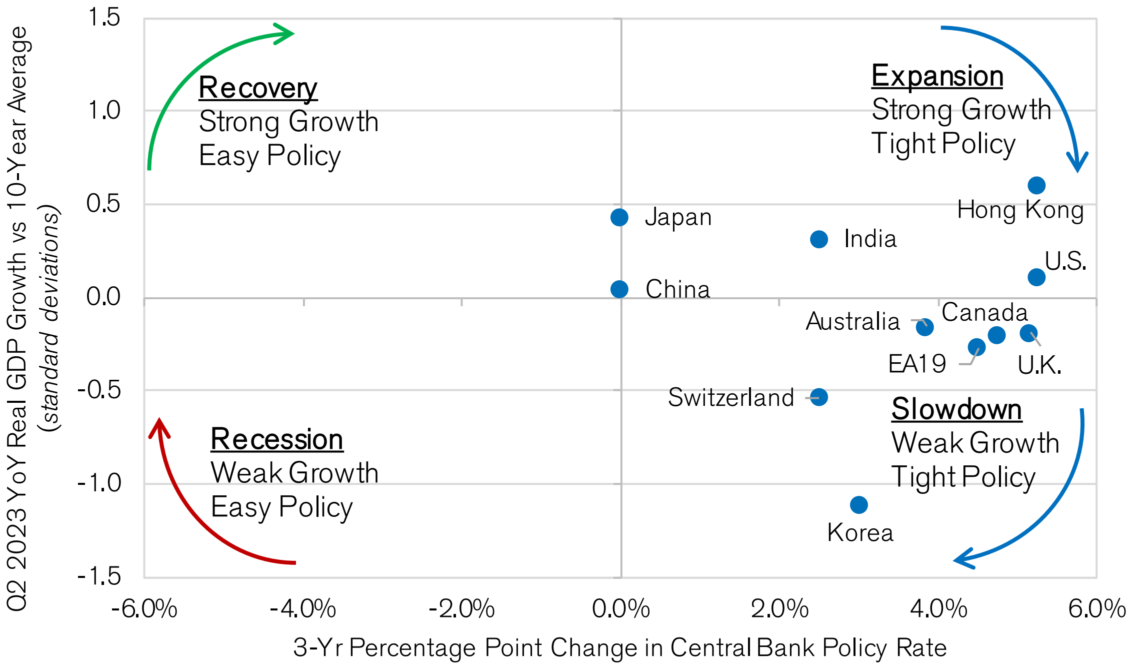
# International Economic & Market Backdrop

# 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 is at-or-below trend in most major economies, and we believe the impact of the synchronized central bank tightening cycle has yet to be fully felt. We remain **overweight defensive regions globally, such as the U.S. and Japan.**

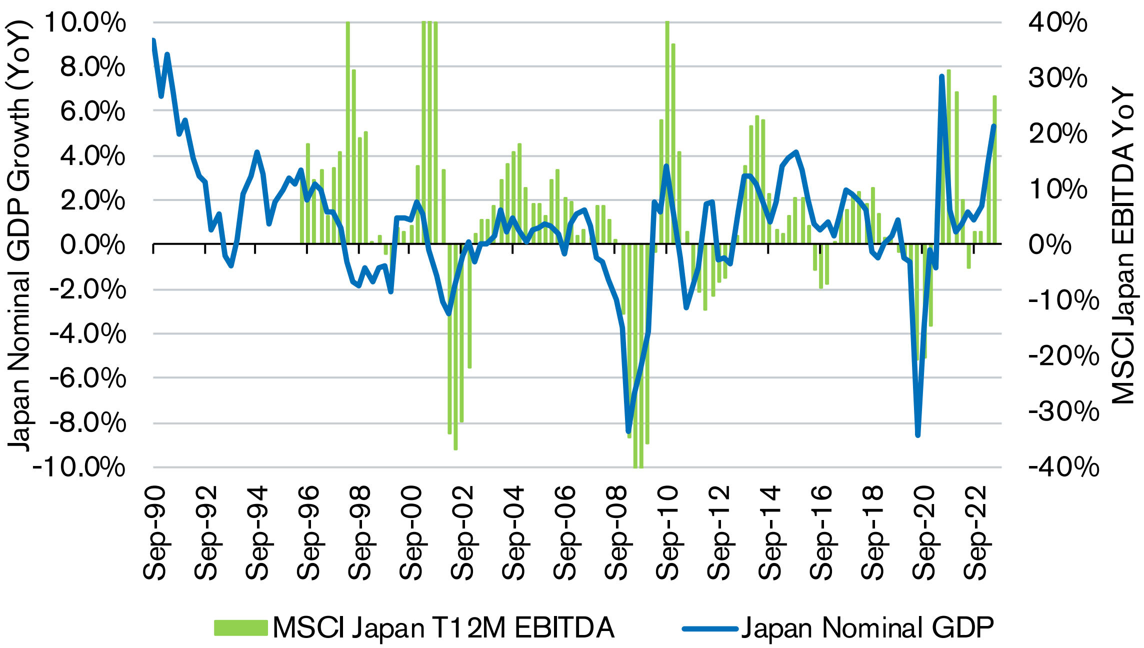
**The U.S., the Eurozone, and the U.K. are all in the later stages of the economic cycle,** in our view, amid **tight monetary conditions and persistently elevated inflation**. Activity in the services sector has been resilient, but economic tailwinds (e.g., excess savings) continue to wane, and we believe **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 in Japan,** 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,** despite an easy year-over-year growth comparison in Q2. The ongoing recovery in services activity has been largely offset by **soft export demand, the property sector downturn, consumer/business caution, and limited stimulus efforts**.

# Improving Nominal Growth Supports Japanese Equities

### JAPAN'S GROWTH PROSPECTS ARE IMPROVING




Source: WestEnd Advisors

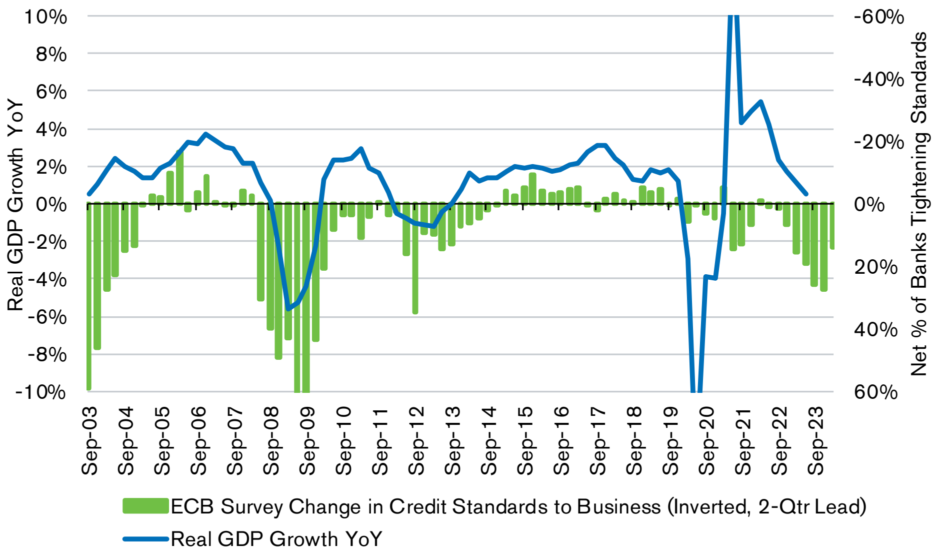
**Portfolio Impact:** We continue to overweight Japan, which not only has **fewer economic headwinds** compared to the rest of the developed world, in our view, but is also typically a more **defensive region during risk-off environments.**

The combination of expansionary real GDP growth and modestly above-target inflation has lifted **Japan's *nominal* GDP growth rate to one of the highest levels in the past thirty years**. Japan has been battling deflationary headwinds in recent decades, and we believe a **higher rate of nominal growth should translate into stronger earnings growth** for Japanese companies.

**We believe the BoJ is likely to remain accommodative in the coming quarters,** as it has signaled it is willing to tolerate above-target inflation in order to support the ongoing economic recovery. While the central bank is currently reviewing its yield curve control policy, we do not expect any abrupt changes in the near term, given that the BoJ has communicated its desire to achieve stable, demand-driven inflation near 2.0%.

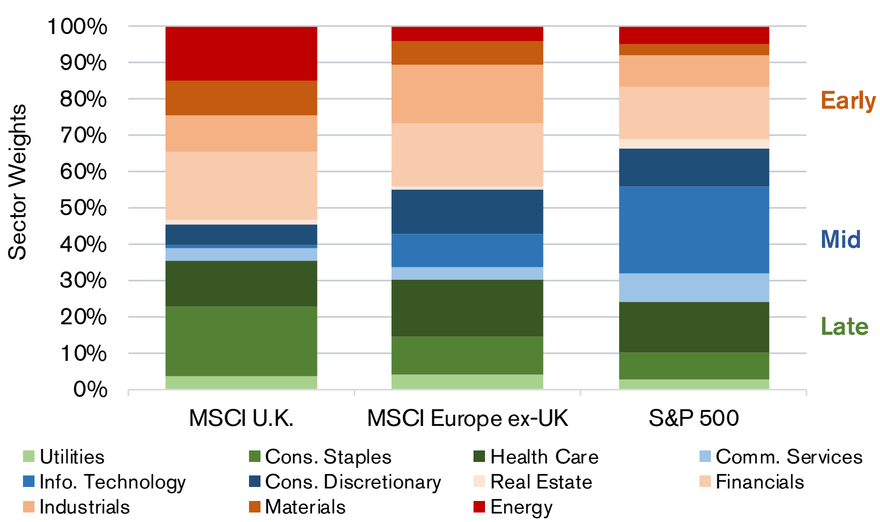
# Europe Exposed to a Cyclical Downturn

## LENDING STANDARDS LIKELY TO WEIGH ON GROWTH




Source: WestEnd Advisors, ECB, Eurostat

## EUROPE HAS MORE EXPOSURE TO EARLY CYCLICALS




Source: Bloomberg, WestEnd Advisors

**Portfolio Impact: Monetary policy tightening, inflationary pressures, and the broad tightening of credit standards pose risks** to Europe's economic growth. As such, we continue to believe that an underweight position is warranted in global portfolios. The region's greater relative exposure to cyclical sectors could lead to **weaker-than-expected earnings outcomes**.

While revised data show the Euro area has avoided a technical recession in 2023, **late-cycle risks have not abated**. The region continues to face several headwinds, including stickier-than-expected inflation, monetary & fiscal tightening, and tightening bank lending standards.

The top chart shows that European banks have tightened lending standards – and expect to tighten further – for businesses and consumers. **Periods of tighter lending standards have historically been associated with slower economic growth** and recession.

While recession risks also appear elevated in the U.S., **Europe has materially more exposure to cyclical sectors that are sensitive to an economic downturn** (see bottom chart).

# Few Signs of Improvement in Emerging Markets

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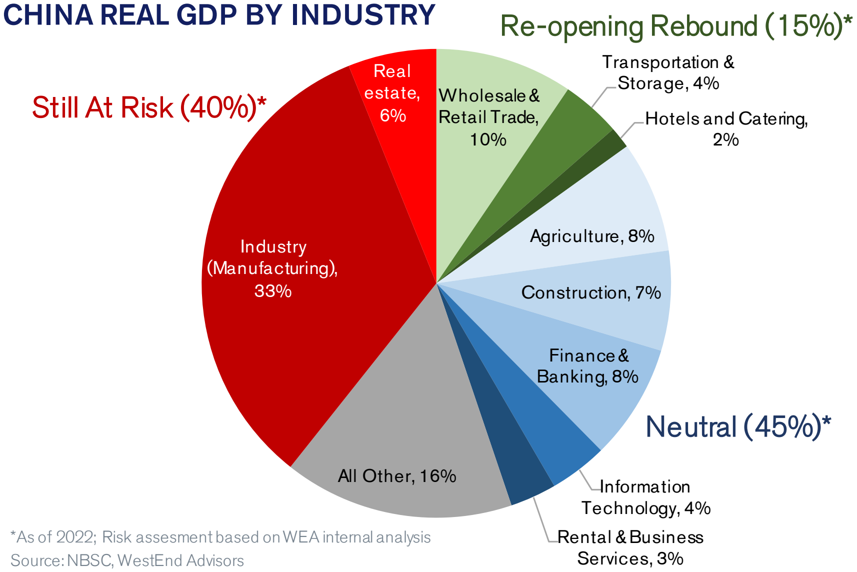
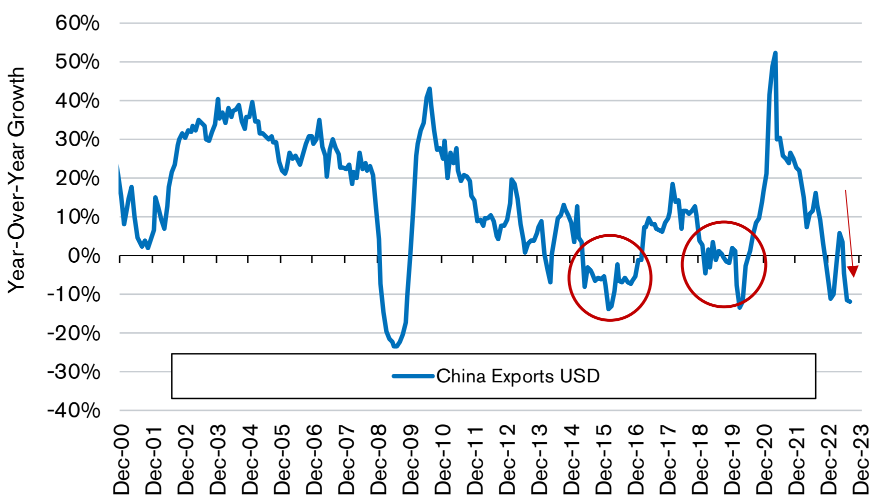
**CHINA REAL GDP BY INDUSTRY**




*As of 2022; Risk assesment based on WEA internal analysis
Source: NBSC, WestEnd Advisors

**SOFT CHINESE EXPORTS SIGNAL WEAK GLOBAL DEMAND**




Source: NBSC

**Portfolio Impact:** As the global economic cycle enters the later stages, we remain **underweight Emerging Markets (EM)** in global portfolios. We anticipate subdued near-term return potential for EM, given its dependence on exports, and do not believe that China's recent stimulus efforts will generate a growth impulse strong enough to offset a global economic downturn.

While real GDP growth in China has accelerated following the removal of COVID-19 restrictions, we believe that softening global demand trends and a more stringent business environment are likely to dampen the country's near-term growth potential. The economic benefits from **China's re-opening have been concentrated in domestic consumption-related industries, which represent a small portion of China's overall economy** (see top chart).

Slowing demand for goods in the U.S. and E.U., which account for ~40% of global GDP, should continue to weigh on production and export growth in EM countries, including China. **During prior periods of slowing global demand, China's export growth remained sluggish for up to two years** (see bottom chart).

# Interest Rates & Real Assets



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# Yield Curve Inversion Signals Late-Stage Economy

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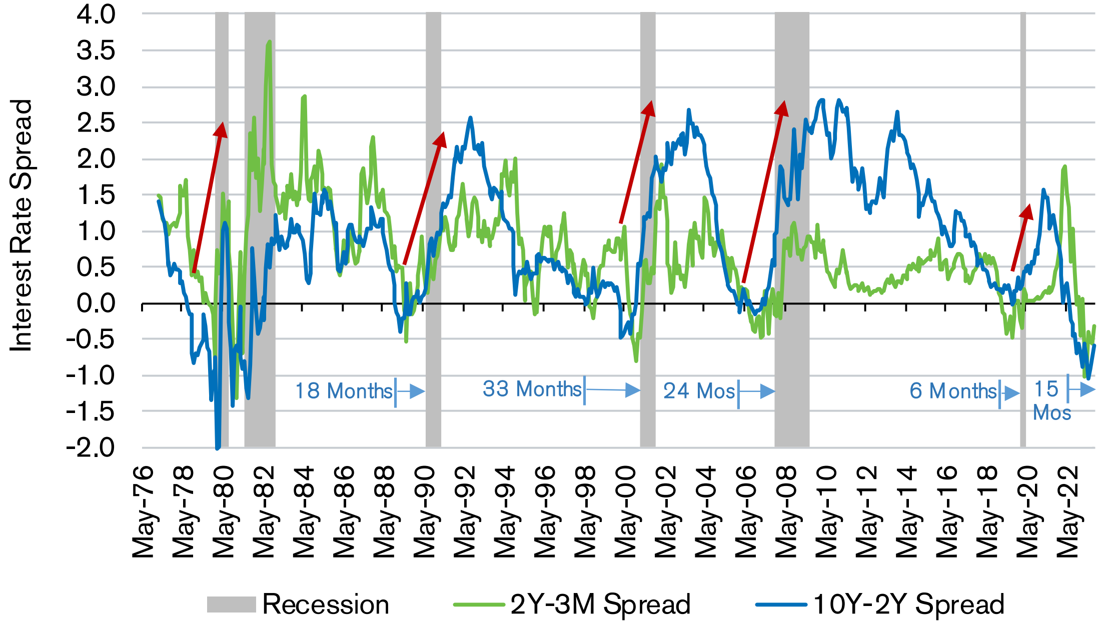
**YIELD CURVE CAN STAY INVERTED FOR EXTENDED PERIODS**




Source: Bloomberg, WestEnd Advisors

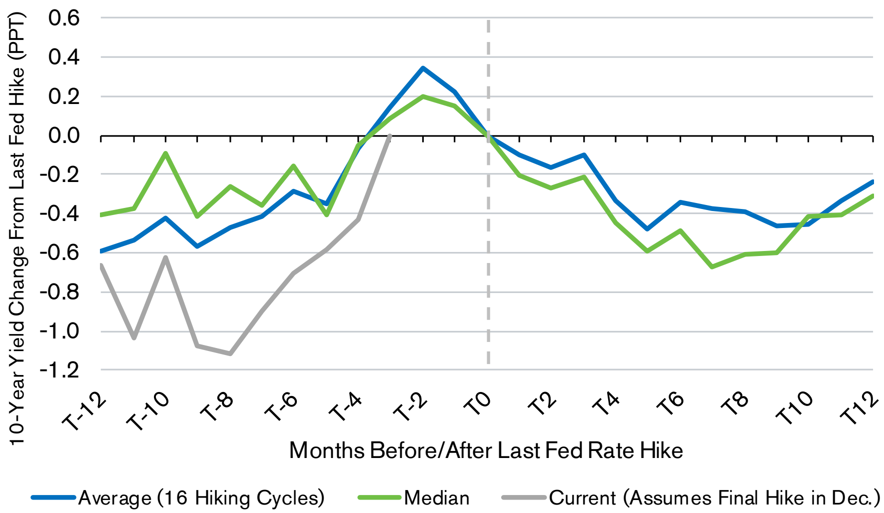
**Portfolio Impact:** Due to potential fallout from Fed tightening and late-cycle conditions, **we see increasing risks to economic growth**. As such, in balanced portfolios, we have reduced our overweight of corporate credit and **added to our defensive intermediate and long-duration Treasury exposure**, which we believe will outperform if growth and inflation surprise to the downside.

Many leading economic indicators suggest that the risk of a recession is elevated in the next 12 months, though the exact timing of its onset is uncertain. As shown in the chart above, **yield curve inversions typically signal that recession risk is rising, but not necessarily imminent.** We see several opportunities to position accordingly within fixed income:

- **Long-duration Treasury bonds** have historically outperformed significantly during recessionary periods, and the risk of a sustained inflationary spiral has diminished, in our view.
- **Treasury floating rate notes** are an attractive defensive allocation, in our view, as the Federal Reserve continues to raise policy rates in order to control inflation. Floating rate securities are insulated from duration risk.
- **Intermediate-and-long duration corporate bonds** are yielding ~120 bps more than the equivalent-maturity Treasury securities and, in our view, are also likely higher quality than short-duration and high-yield corporate credit.

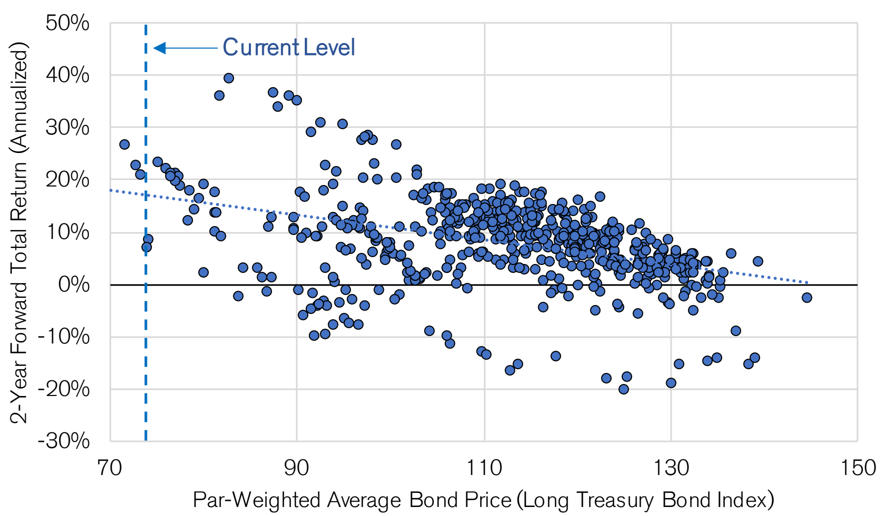
# Fixed Income Return Potential Improves with Higher Rates

LONG END OF THE CURVE TYPICALLY PEAKS AROUND LAST FED HIKE




Source: WestEnd Advisors

POTENTIAL RETURNS FOR LONG TREASURIES ARE ATTRACTIVE




Source: Bloomberg, WestEnd Advisors

**Portfolio Impact:** Recent disinflationary trends, coupled with mounting risks to the economic backdrop, **indicate limited upside risk to long-term interest rates** from current levels over the intermediate term. As a result, **we maintain an overweight allocation to long-duration fixed income** in balanced portfolios.

Following the rapid rise in interest rates since the beginning of 2022, **we believe the risk for long-term rates is likely skewed to the downside within our investment window,** given that the Fed is likely near a sufficiently restrictive policy stance (see top chart).

Historically, when long-duration Treasury bond prices have been at-or-below current levels, returns over the subsequent two years have been consistently positive and often well above average. **We see attractive return opportunities in fixed income given our interest rate outlook**.

# Macro Risks Present Headwinds for Credit

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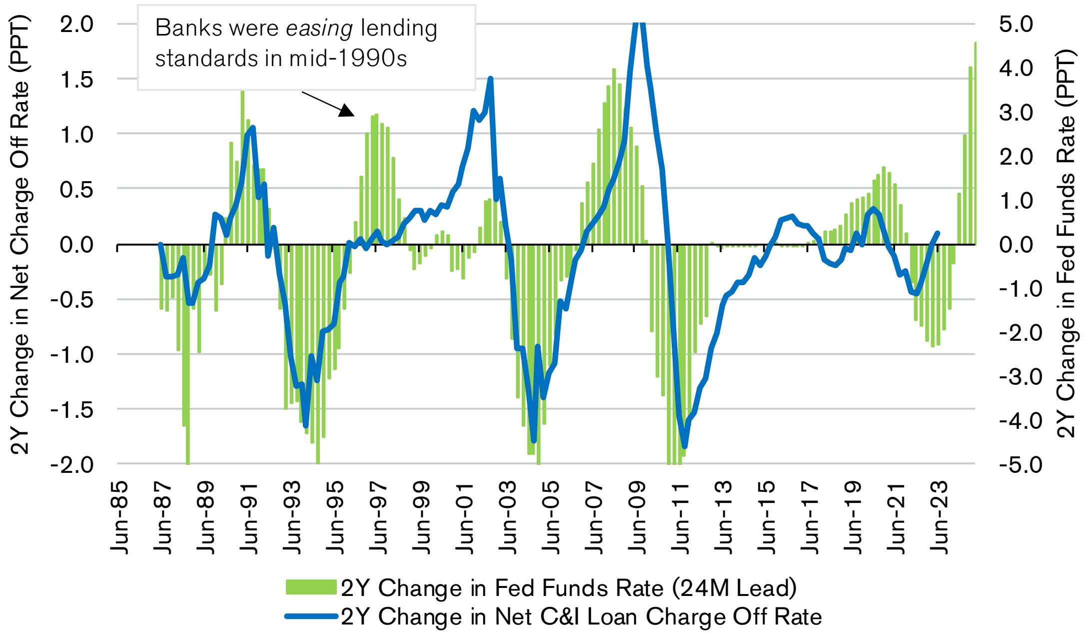
### CREDIT DETERIORATION HAS ONLY JUST BEGUN



Source: WestEnd Advisors

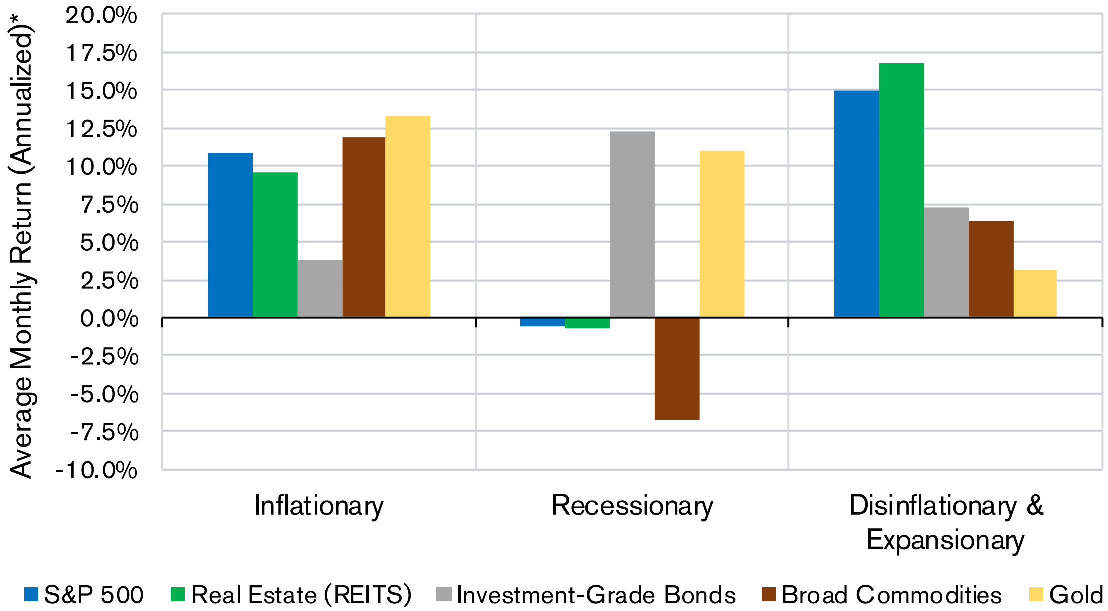
**Portfolio Impact:** Rising net charge-offs for loans are typical at this point in the cycle. **Higher interest costs, lower credit availability, and decelerating profits growth** have the potential to weigh on credit markets in the next 18 months, in our view. As such, we have moved to an **underweight of corporate credit** within fixed income allocations.

Monetary policy tightening cycles raise interest expenses for both households and businesses and are intended to slow economic growth and inflation. The chart above demonstrates that **changes in the Federal Funds Rate have historically *led* changes in C&I loan net charge-offs by as much as 2 years.**

During the last "soft-landing" in the mid-1990s, banks were easing lending standards, unlike the rapid tightening we have experienced this cycle. As a result, we believe there is a **high probability that credit fundamentals deteriorate further over the next 18 months**.

# Asset Class Returns Driven by Macro Environment

## MACRO CONDITIONS DRIVE ASSET CLASS DISPERSION




Source: Bloomberg, WestEnd Advisors *Covers all periods since 1975.

**Portfolio Impact:** Moving forward, we see a growing likelihood that recent inflation pressures fade as the risk of recession rises. As such, we are **emphasizing fixed income and gold in our multi-asset portfolios**, while underweighting or avoiding the most economically sensitive assets, such as equities, real estate, and broad commodities.

The economic and market volatility exhibited so far this cycle have showcased that asset class performance can vary significantly depending on the underlying economic environment. During inflationary environments, such as we experienced in 2021 and 2022, we believe commodities can add significant capital appreciation potential and inflation protection to a portfolio.

However, as we look ahead to late 2023 and 2024, **we believe there is potential for the inflationary backdrop to shift into one of deteriorating economic growth**. As such, we have repositioned our multi-asset portfolios to protect capital in the event of a downturn. As the chart above shows, investment grade bonds and gold have historically outperformed other asset classes during recessions.

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# Footnotes & Disclosures

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