

May You Invest in Interesting Times

Amid noisy data and policy uncertainty, we see risk of near-term economic deceleration, but evolving growth drivers still could extend growth in the intermediate term. We are positioned for this environment with a mix of defensive and economically sensitive exposures to manage risk and opportunities.

SUMMARY

- With noisy economic data and elevated policy uncertainty, Q1 2025 posted the worst quarterly U.S. equity returns since 2022.
- We expect near-term economic deceleration in the U.S., given renewed economic risks, but we also see potential for extended late-cycle growth in the intermediate term.
- Amid elevated valuations, we expect earnings growth to be the key driver of equity returns in the U.S. this year.
- Global economies and markets face lingering economic headwinds in addition to risks from U.S. tariffs.
- We expect a steepening of the yield curve this year and see a neutral risk/return profile for fixed income in balanced portfolios.

Q1 2025 REVIEW

The first quarter of 2025 (Q1) was characterized by noisy economic data and sharp increases in economic, policy, and market uncertainty in the U.S. Personal income growth accelerated in the first two months of Q1, but that was due to transfer payments, including a Social Security cost-of-living adjustment and large class action legal settlements. Personal consumption expenditures were more volatile, posting their largest monthly decline since early 2021 in January, but rebounding toward trend growth in February. Consumer expectations for the economy slid toward pandemic-era lows in March. Non-farm payroll gains were fairly steady through February but, due to the timing of the survey, that largely excludes the impact of government layoffs and private sector layoffs tied to government funding cuts. Further, while February's headline unemployment rate was in line with year-end, the U-6 measure of unemployment, which also includes *underemployed* workers, spiked to its highest level since 2021.

Much of the economic and sentiment volatility in Q1 seems tied to policy uncertainty. On-again/off-again tariff threats have stoked both inflation fears and trade policy uncertainty that can impede corporate investment decisions, while more pro-growth policies like tax cuts and deregulation have received less attention. Chaotic efforts by the Department of Government Efficiency (DOGE) to slash government spending have driven concerns over the future of various government programs and grants, as well as employment levels. How much this will impact the economy remains an open question.

Noise and Uncertainty

In Q1, noisy economic data and policy uncertainty underpinned the worst quarter for U.S. stocks since 2022.

The S&P 500 returned -4.3% in Q1, effectively erasing its post-election rally amid the increased uncertainty. Consumer Discretionary was the worst-performing U.S. sector in Q1, reflecting declining consumer expectations for the economy and a sharp decline in Tesla, Inc. (TSLA), one of the largest sector constituents. Information Technology and Communication Services sector returns were also negative, with news of low-cost AI competition from China weighing on valuations for some AI-related firms. This helped sector leadership broaden out to a mix of both cyclical and defensive sectors, including Energy, Health Care, Utilities, and Consumer Staples. An underweight of Information Technology and overweights of Health Care, Consumer Staples, and Financials within U.S. allocations contributed positively to relative performance across our portfolios.

International markets, in contrast, had mostly positive returns in Q1, with dollar weakness further boosting returns for U.S.-based investors. Repatriation of investments may have contributed to both local market returns and dollar weakness. Europe and emerging markets (esp. China) led global markets in the quarter, where shifts toward increased fiscal support may have buoyed investor outlooks. Japanese equities sold off near quarter-end as the U.S. announced likely tariffs on all auto imports, but yen strength drove slightly positive Japanese equity returns for dollar-based investors.

Bonds generally rose during the quarter. While Treasury yields declined, corporate spreads widened amid economic uncertainty.

OUTLOOK

Overview. We still see late-cycle economic conditions in place in the U.S. While we believe some near-term economic deceleration is likely, tied in part to policy uncertainty, the *duration* and *magnitude* of a

slowdown remain key questions for portfolio positioning. In the intermediate and longer term, we anticipate a further extension of the economic cycle is reasonably likely, even if activity slows in the near term, particularly if the administration's policy focus shifts toward more stimulative measures like tax cuts and deregulation. We expect more clarity on this as the year progresses.

For U.S. equities, we believe valuations remain challenged, especially for tech-related sectors despite their recent pullback, and we continue to expect earnings growth will be the primary driver of equity returns over the next year. Volatility tied to economic and monetary policy uncertainty is also likely to persist, in our view. Given this backdrop, we retain a balance of select defensive and economically sensitive U.S. sector exposures across portfolios.

Globally, we do see some tentative shifts toward more stimulative fiscal policy, but we continue to expect U.S. economic growth will remain more favorable in the intermediate term. We believe our select U.S. sector allocations should outpace most international equities, in aggregate. Thus, we remain modestly underweight international equities in global portfolios.

For fixed income markets, we see a fairly neutral risk/return profile but note risk to longer-term corporates from a potential widening of credit spreads. We have positioned balanced portfolios accordingly.

U.S.: The U.S. macroeconomic, political, and market landscapes have been shifting in various ways in recent months. Key factors that have helped extend growth this economic cycle appear to be fading. In some cases, growth drivers may face additional policy headwinds. Tariffs that may be imposed can be disruptive to trade and could stoke inflationary pressures, and the uncertainty around tariff policies could further inhibit companies' ability to plan and willingness to make investments. Immigration policy shifts and government spending cuts could also have material near-term impacts on growth.

We have seen significant noise in hard economic data in recent months. This includes what appears to be demand pull-forward ahead of potential tariffs, which may have supported the surge in new durable goods orders this year as well as a buildup of manufacturing and wholesale inventories. This demand, however, could reverse quickly in the near-term as tariffs are enacted. Natural disasters, including significant winter storms and wildfires across the country, also appeared to impact employment, income, and consumption data.

While last year could be characterized as a disinflationary late-cycle expansion, the disinflationary trend seems to have largely stalled, leaving a question mark for the direction of monetary policy. Core PCE inflation has settled in the 2.7%-2.9% range year-over-year since Q3, and tariff policy has the potential to increase inflationary pressures. The Fed seems to be taking a wait-and-see approach in the near-term, with only three cuts expected by markets in 2025.

While consumer incomes have continued to grow at a healthy pace in recent quarters, the decline in consumer confidence amid market volatility in Q1 and renewed inflation concerns suggest consumers

could start pulling back. We have already seen declines in some key discretionary spending categories, like travel and restaurant spending. We have also seen disposable income growth slow from above-average back toward its long-term trend, and aggregate income growth could be threatened by a slowdown in employment growth, which has been a key driver of late-cycle income growth that supported consumption in this expansion. Payrolls growth, however, has been narrow in recent quarters, largely driven by Education & Health and Government jobs. We see these pillars at risk from policy shifts, including federal workforce reduction and cuts to federal funding that supports private employment.

While we see risks, we also see likely drivers for a potential extension of late-cycle growth. One area of support for consumption, in our view, has been the rapid accumulation of household wealth that has occurred in recent years, driven, in part, by housing and equity market appreciation. We believe the wealth effect helped personal consumption growth outpace disposable income growth last year. If sentiment and markets stabilize, healthy household and business balance sheets could allow for the use of credit and re-leveraging to drive growth in consumer spending and business investment. In this regard, a near-term slowdown in economic activity could help set the stage for a reacceleration by allowing for lower short-term interest rates that could spur borrowing.

Productivity gains could also provide upside to growth and incomes. Labor productivity has been above the trend of the 2010s expansion in recent quarters. Large AI investments, which companies have been making and citing as beneficial, as well as other technology investment that is common late in the cycle, should help support productivity gains over the coming year, in our view.

Further, the current administration's policy focus is likely to evolve, in our view. In contrast to the first Trump administration, when initial efforts were focused on more stimulative priorities such as tax cuts, the initial rush of activity for the current administration has been trade, foreign policy, and reshaping the federal bureaucracy. As the administration makes progress or faces pushback on these efforts, it could shift to other priorities, including tax cuts and greater emphasis on deregulation, which could boost economic optimism. While a near-term deceleration in growth amid uncertainty seems likely, we see a balance of risks and support for the economy in the intermediate term, and we expect to gain increased clarity on the potential for an extension of the cycle in the coming weeks and months.

For U.S. equities, we continue to believe earnings can drive positive U.S. equity returns this year, absent an increase in the likelihood of an extended economic slowdown. While earnings estimates for the S&P 500 have come down somewhat since the start of the year, especially for economically cyclical, early-phase sectors like Industrials and Materials, the expected earnings growth rate for the index as a whole remains around 10% for 2025. Meanwhile, valuations remain

Looking Past the Noise

Uncertainty may contribute to near-term economic deceleration, but we still see potential for extension of late-cycle growth this year.

elevated, in our view, but have come down somewhat this year. We do expect competing economic and market pressures could foster continued volatility for equities in the near-term, but we believe markets have the potential to largely look past a near-term deceleration in economic growth.

In U.S. equity allocations across portfolios, we are balancing this return opportunity against near-term risks through a mix of defensive late-phase sectors, such as Health Care and Consumer Staples, and select economically sensitive sectors where we see particular growth opportunities. These include Information Technology, where we have increased Software exposure that should be less impacted by tariffs and cyclical factors than hardware; Communication Services; and Financials. We continue to avoid the most cyclical early-phase sectors, like Industrials and Materials.

International: While we have seen some shifts toward stimulus in Europe and China, we believe their impact may be limited and continue to see relative headwinds for many international markets. Potential shifts in EU defense spending have generated market enthusiasm for the region, but these initiatives will take time to implement and are likely to be narrowly focused, in our view. Meanwhile, Europe continues to face risks tied to the war in Ukraine and potential U.S. tariffs, and currency strength in Europe could be a headwind for the region's earnings. In our view, all this warrants caution after valuation multiples in segments of the European market have moved significantly higher this year.

Global Headwinds

Despite recent equity market strength, we see ongoing headwinds for international markets, including new U.S. tariffs that could weigh on demand and economic growth.

Emerging markets tend to be very economically sensitive, and they face risk from slow global growth as well as direct demand impacts if U.S. tariffs

are widely implemented. We see China's strength as a key input for broad emerging markets to perform well on a relative basis. Prior episodes of Chinese market and economic strength have been led by new credit being injected into the economy, as measured by the credit impulse (the change in new credit as a percent of GDP). Historically, rising credit impulse in China has tended to lead market recoveries by about six months, but it appears China's recent market upturn has run ahead of the macro environment, so we remain skeptical of Chinese markets and broader emerging market equities.

Japan remains a relative international bright spot, in our view. Japan's real economic growth has rebounded in the past two quarters, and core inflation has remained fairly stable around the 2% to 3% range over the past two years. Meanwhile, it retains the most stimulative monetary policy among major developed countries, despite recent and likely future rate increases. The yen is undervalued, in our view, and modest rate increases combined with continued economic growth and the country's perceived defensive status could all help support relative strength for the yen versus other major foreign currencies. This, in turn, should benefit Japanese equity returns relative to other international equities for dollar-denominated investors.

Given these considerations, we continue to underweight international equities in global portfolios. Specifically, we are underweight Europe and emerging markets, but we maintain an overweight to Developed Asia, and particularly Japan.

Fixed Income and Real Assets: The primary reason, in our view, for inclusion of fixed income or real assets in balanced or multi-asset portfolios is diversification, typically at a cost of lower expected long-term returns. While balanced investors may still feel stung by 2022, when fixed income mostly failed to diversify against equity downside, we are seeing a more normalized fixed income environment today. With bond yields at relatively healthy levels, we believe fixed income is positioned to play its traditional diversifying role, though its risk/return profile appears neutral. Thus, we have eliminated an overweight of fixed income in traditional balanced strategies.

The 10-year Treasury yield ended Q1 around 4.2%. That provides some cushion for bond returns in the event that longer-term yields rise in 2025 amid continued economic growth. Although the Treasury yield curve is positively sloped starting in the 1-to-3-year range, it is inverted at the short end, as the Fed is on hold with a 4.25% to 4.50% target range for Fed Funds. In the event, however, of a sustained deceleration in growth, we would expect Fed rate cuts and renewed disinflation could help push yields downward.

Meanwhile, credits spreads for corporate bonds recently widened a bit but remain near multi-decade lows. Given the risk of near-term economic deceleration, along with rising interest costs for companies as they refinance lower-cost debt, we see risk for further credit spread widening that could materially depress longer-term corporate bond returns. Thus, while we maintain Treasury exposure at the longer end of the yield curve in balance accounts, we have consolidated our corporate exposure in shorter duration securities that are less sensitive to changes in credit spreads.

In multi-asset portfolios, we have also made adjustments within real asset exposure. Given late-cycle conditions, we continue to avoid the most economically sensitive real asset exposures, like real estate and broad commodities. We maintain an allocation to energy infrastructure, but we have trimmed that exposure as valuations appear elevated relative to fundamentals. We have increased exposure to gold, which we expect could benefit in either an inflationary or a recessionary environment.

CONCLUSION

We continue to see significant active opportunities within our 6 to 18-month investment horizon, despite the near-term risk of economic deceleration and policy uncertainty, and we have positioned portfolios to balance those opportunities and risks. As always, we will adjust portfolios as our macroeconomic and market outlooks evolve.

WestEnd Advisors Investment Team | April 1, 2025

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