Second Quarter 2020 Economic and Market Outlook

Wescott Financial Advisory Group LLC

Philadelphia | Fort Washington | Miami | 215.979.1600 | www.wescott.com

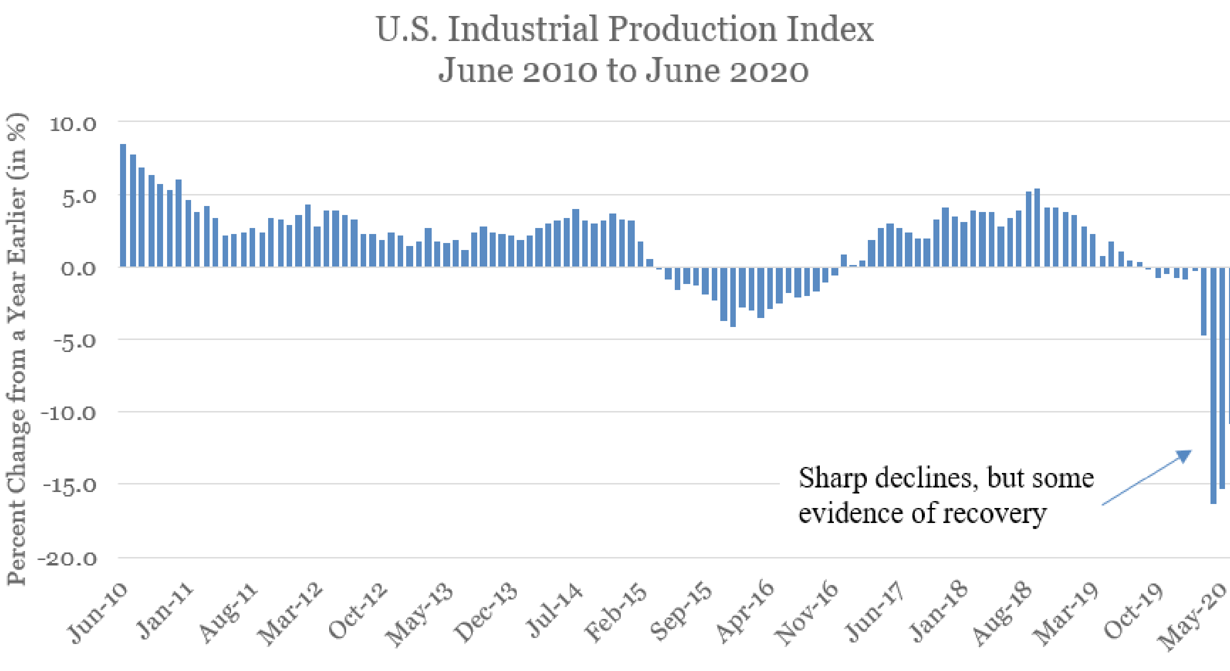
We noted in our first quarter outlook that if actions taken by governments around the world prove successful in slowing and ultimately containing the spread of COVID-19 in the coming months, the global economy may start to recover by late summer. Several states in the U.S. and some emerging markets are now experiencing substantially increasing daily virus cases. State and global economies had begun opening up and there is evidence of a nascent recovery. How the resurgence in the US and in some other countries are handles and controlled will impact the recovery in the months ahead.

As we continue to reopen, many of the measures designed to limit the spread of the virus, such as social distancing and periodic quarantines, will still be necessary until a proven vaccine is produced and distributed. The decisive policy response by Congress and the Federal Reserve has limited, but did not eliminate, the impact to the economy. However, these actions will likely provide a solid foundation for an eventual recovery once an effective and safe vaccine is developed and distributed.

The global economy is currently experiencing one of the sharpest recessions in history. According to the International Monetary Fund (IMF), the global lockdowns necessary to contain the spread of the global pandemic will cause global economic growth to fall to -3.0% and U.S. economic growth to fall to -5.9% in 2020. This is a far cry from the + 2.5% positive growth that many expected for the U.S. at the start of the year.

U.S. Industrial Production, which measures economic activity in the manufacturing, mining and utilities sectors shows the impact the "stay at home" orders have had on U.S. businesses in March and April, but there are indications that activity is picking up again in recent months. In fact, the index rose 5.4% in June 2020 marking the second straight positive month.

Figure 1: Some signs of recovery are showing up in Key Economic Activity Indicators

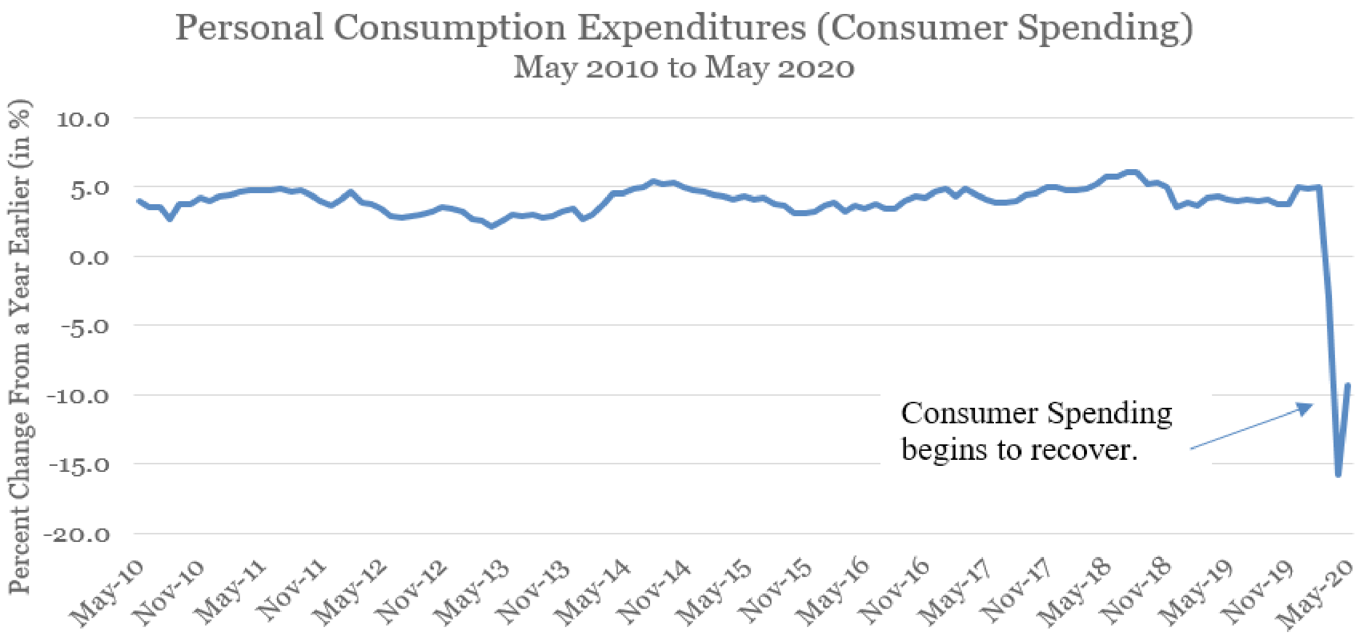


Source: Board of Governors of the Federal Reserve System (US), Industrial Production Index [INDPRO], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/INDPRO, July 15, 2020.

Consumer Spending Rebounds in May and June 2020

Despite the unprecedented spike in unemployment, consumer spending has improved recently after falling significantly in March and April of this year. A large part of this rebound can be attributed to the Federal economic recovery payments made in April as part of the CARES Act, a fiscal stimulus package that among other programs, provided income to those who lost their jobs. This increased personal income in April by 10.5% which led to an 8.2% increase in personal consumption in May. In addition, as states began a staged reopening, many of the temporarily unemployed began to go back to work. While the consumption rebound in the last few months is encouraging, there is a risk of a further delay if a resurgence and/or second wave results in delayed openings. In addition, there may be a long-term structural shift in consumer behavior which will be important to monitor, particularly spending on non-essential items such as travel and leisure which remain well below normal levels.

Figure 2: Personal Consumption Rebounds Following Economic Stimulus Payments



Source: Federal Reserve Bank of St. Louis FRED as of May 31, 2020. U.S. Bureau of Economic Analysis, Personal Consumption Expenditures [PCE].

While it is still quite early in the recovery, we are encouraged by the rebound in manufacturing and consumer spending. This suggests that the Federal economic recovery payments, combined with the lowering of interest rates by the Federal Reserve, have been successful in keeping the economy afloat in the short term. Interestingly, sales of bigger ticket items such as automobiles and houses have been up in recent months, perhaps benefiting from the lower borrowing rates available. While there has been some improvement, a full recovery in global economic activity will be unlikely until, ultimately, a safe and effective vaccine is developed and administered globally.

U.S. Presidential Election 2020 Introduces Additional Uncertainty

Among the many risks to the recovery, including a second wave of the virus that would delay further opening, the upcoming U.S. Presidential Election will likely be a significant source of uncertainty. While there are many studies on how markets behave during election years, and during Republican or Democratic administrations, the current situation is unlike many others, making comparisons and predictions difficult. We do not attempt to make predictions on who the ultimate winner will be in November, nor do we position portfolios for a specific outcome. However, from an investment point of view, it is important to consider the alternatives and the potential impact on markets.

There is no shortages of polls covering the upcoming Presidential race. No matter what your politics, these polls do have a tendency to move investment markets over the short term, although fiscal and monetary policy tend to be the most important factors to consider when evaluating the longer-term market impacts.

Current national polls[1] show Biden in the lead as of today. While this may change between now and November, the markets will begin to make assumptions on the economic policies of the eventual winner, from trade and tax policy to infrastructure

spending plans. What makes this year different, however, is that both candidates and Congress know that getting the virus under control and getting the economy back on track are the two most important issues.

Our Outlook

While continued increases in virus cases in the U.S. are unnerving and could make the ultimate recovery slower than what it would have been, we do expect the economy to improve going forward. As states open up, people will go back to work and spending on both essential and increasingly non-essential items will slowly recover.

The risks ahead are still significant. It is possible that certain sectors, industries and companies do not make a full recovery. We have seen major banks preparing their balance sheets for the likelihood that some of their outstanding loans will go unpaid and some of their corporate customers may also default. This was evident in the most recent financial results updates from banks such as JP Morgan Chase, Bank of America, Morgan Stanley and Goldman Sachs.

Importantly, the banking sector is stronger today given the increased capital requirements they must maintain to meet financial regulations put in place after the credit crisis in 2009. In addition, the policy response by the Federal Reserve and U.S. Congress has been quick and effective so far.

From an investment perspective, with the current dampened demand for things like global travel, more use of videoconferencing today and in the future, and the potential for a sustained change in consumer behavior as a result of the financial stress many are currently feeling, maintaining a portfolio of high-quality companies with the financial strength to make it through this sudden downturn will be important. It will position portfolios well going forward.

However, as companies most exposed to the economic cycle begin to benefit from its recovery, the opportunity to capture strong returns in sectors and companies that are currently out of favor becomes more attractive. Portfolios with exposure to both economically defensive companies and economically sensitive provide a balanced approach to the uncertain future ahead.

Contact Us

If you would like to learn more, please visit us at www.wescott.com, or contact us at 215.979.1600. We would love to hear from you.

1 Real Clear Politics (www.realclearpolitics.com), NBC News/WSJ (https://www.nbcnews.com/politics/2020-presidential-election), Fox News (https://www.foxnews.com/politics), Predictit (https://www.predictit.org/) or FiveThirtyEight (https://projects.fivethirtyeight.com/polls/president-general/national)

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