WestEnd Advisors

Macroeconomic Highlights

October 2013

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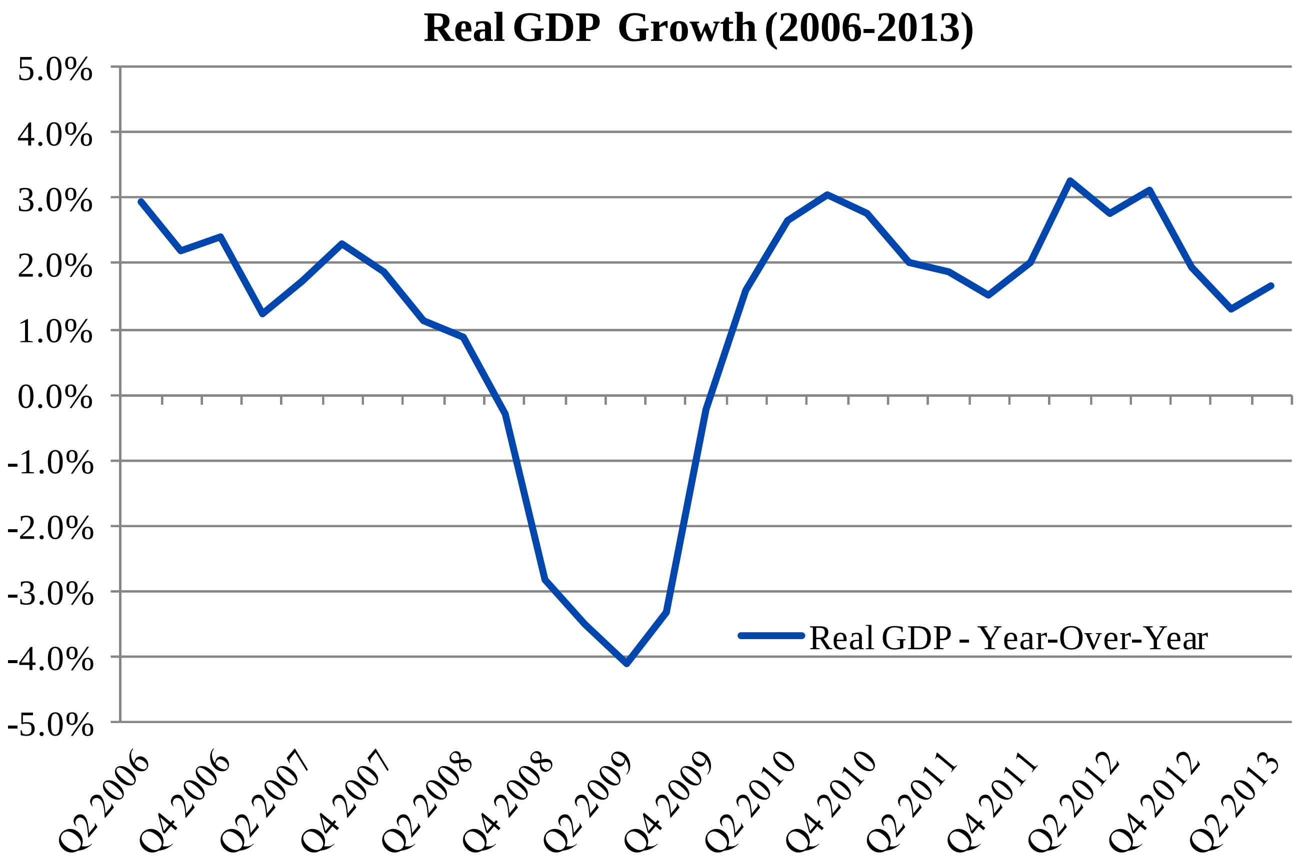
Economic Recovery Advances with Slow Growth



Source: Bureau of Economic Analysis

U.S. economy continues to grow, but the pace of growth has shifted lower. In the first two quarters of 2013, Final Sales, which removes the impact of inventory, recorded the two slowest quarters of growth out of the last nine quarters. Similarly, the year-over-year change in GDP growth was below 2% for the second consecutive quarter in Q2 2013. Q3 readings to date point to continued modest GDP growth in the third quarter.

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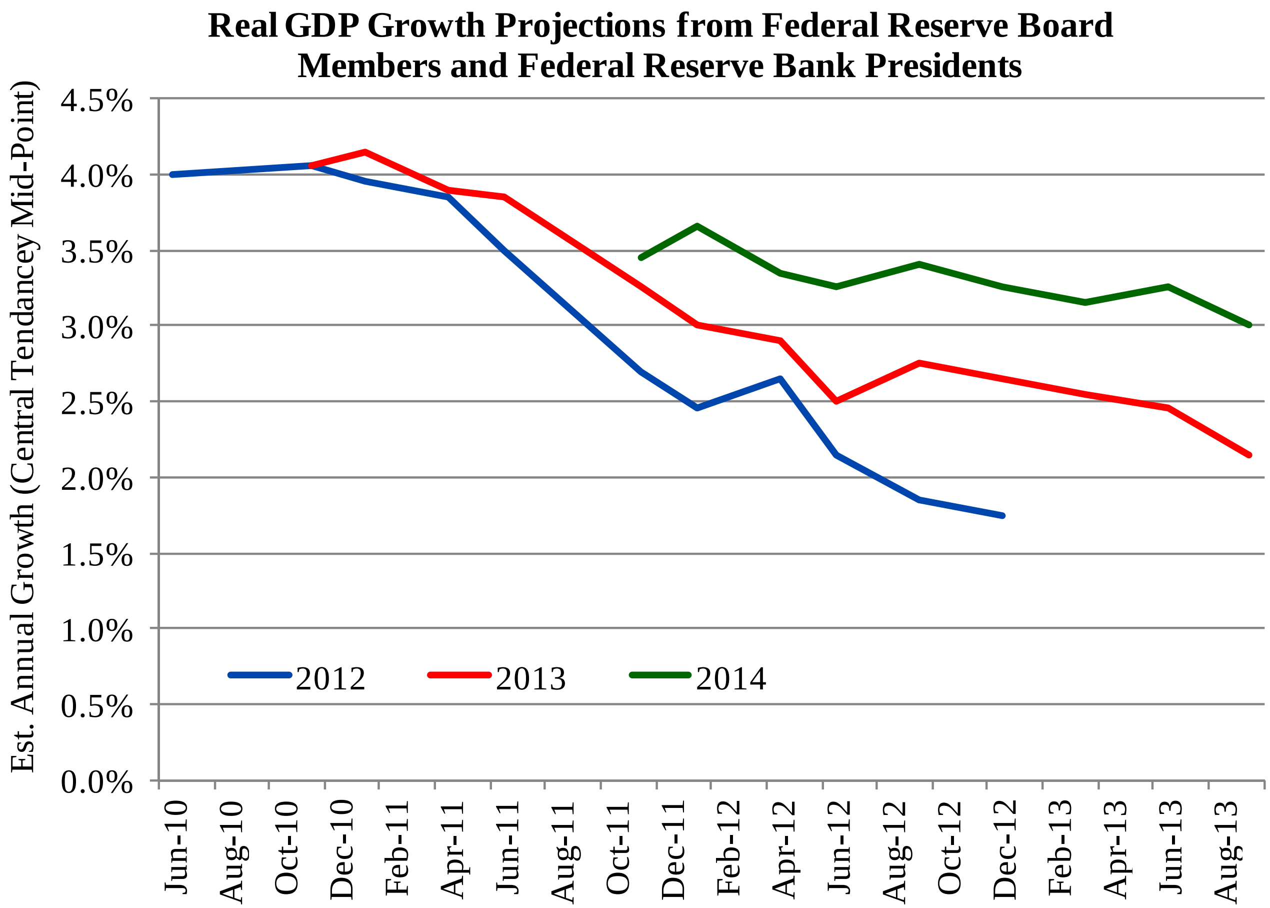
Economic Growth Expectations Continue to Shift Lower



Source: The Federal Reserve

Federal Reserve officials and many investors have anticipated a pickup in economic growth, but that improved level of economic activity has not materialized. The consensus at the Fed in 2010 was that U.S. GDP growth would be 4% in 2012 and 2013. Projections for those years have fallen over time as growth has been weaker than expected. We anticipated moderate economic growth in 2012 and 2013, and we continue to expect that unexciting growth will persist as less risk-taking, higher taxes and a rationalization of credit will be a headwind to more dynamic economic growth. At the same time, with fewer excesses across the economy, we believe that the economy can grow at a moderate pace for an extended period.

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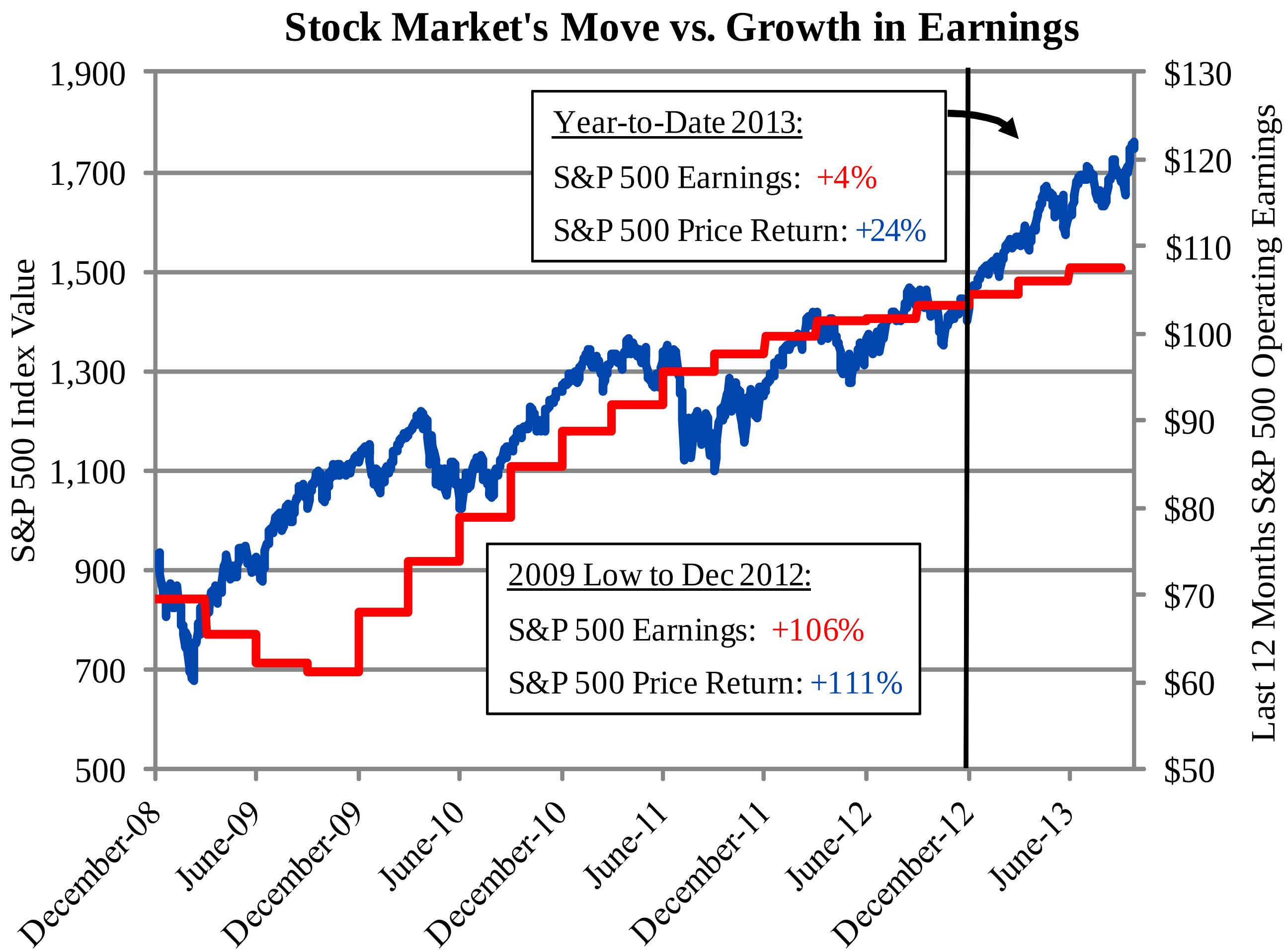
Stock Market Gains Have Outpaced Earnings Gains in 2013



Source: Thomson Reuters, Morgan Stanley, WestEnd Advisors

The S&P 500 Index rose 111% from the 2009 low through the end of 2012. This increase the stock market was supported by a 106% increase in S&P 500 earnings from the 2009 trough in earnings. More recently, the rise in the stock market has outpaced the increase in earnings. We expect that the stock market will likely move sideways, with the most economically sensitive Sectors of the market like Materials, Energy and Financials most vulnerable to earnings disappointments.

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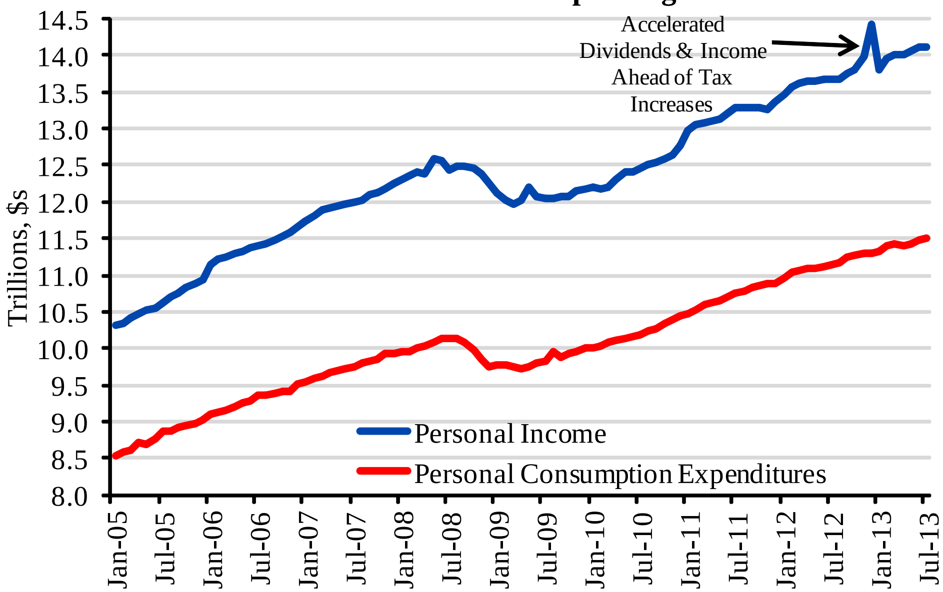
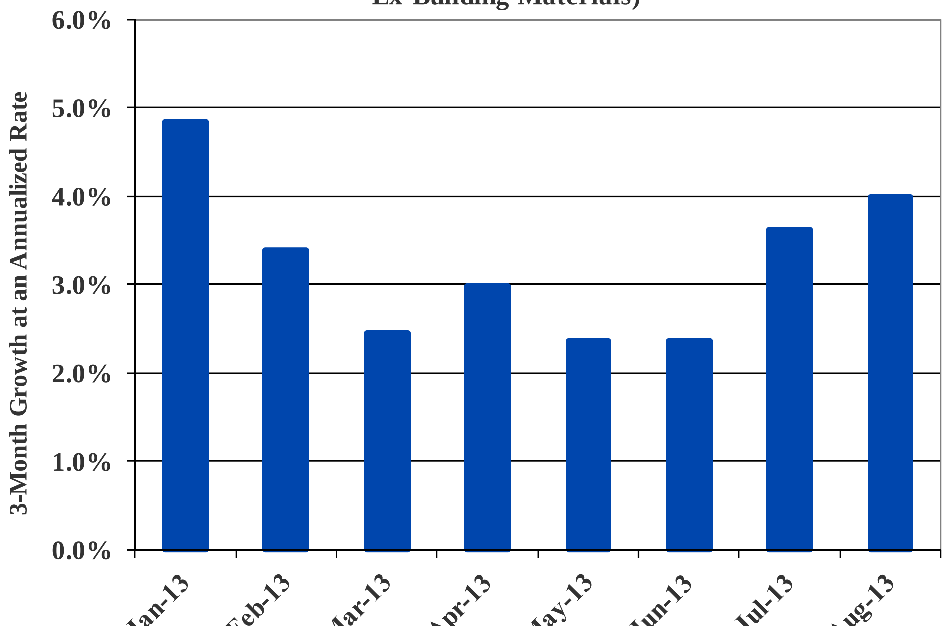
Consumer Spending – Reliable Source of Growth

Personal Income and Spending



Source: Commerce Department, Bureau of Economic Analysis

Monthly Core Retail Sales (Ex-Auto, Ex-Gas and Ex-Building Materials)



Source: Commerce Department

Consumer spending was the largest contributor to GDP growth in the first half of 2013 as personal spending benefited from solid income growth. Income growth and a high sense of job security continue to drive spending gains.

Wages and salaries are the largest component of Personal Income. Wages and salaries are 8.2% above the previous high from March 2008, even though payrolls remain 1.1% below the January 2008 peak in payrolls.

Core retail sales, which exclude the impact of gas station sales, auto sales and building materials sales, rose at a healthy 4.0% annualized pace for the three months ended August. This was the strongest growth in the last seven months.

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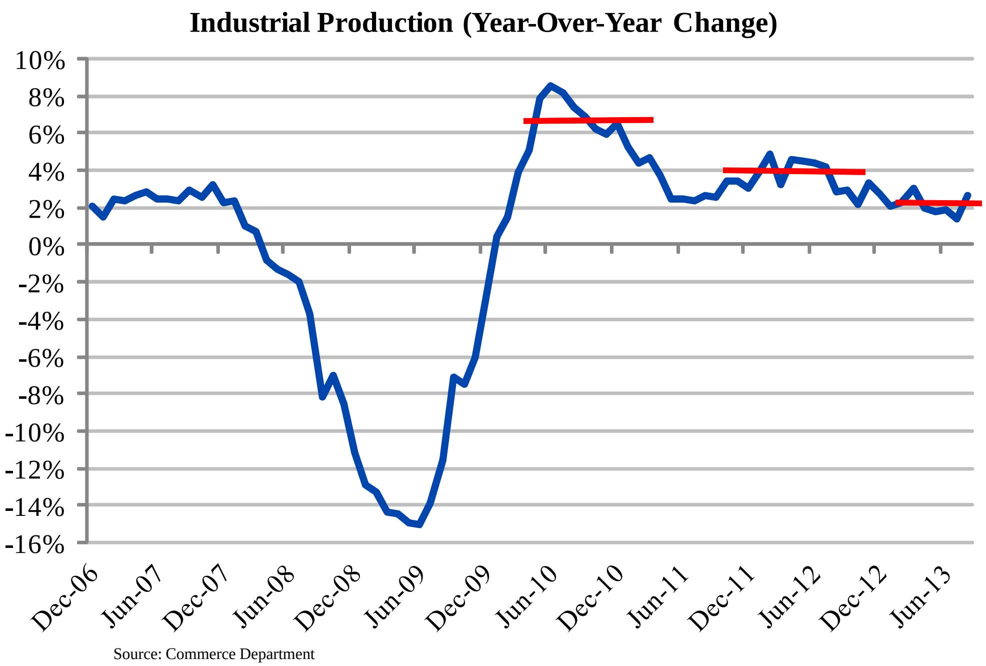
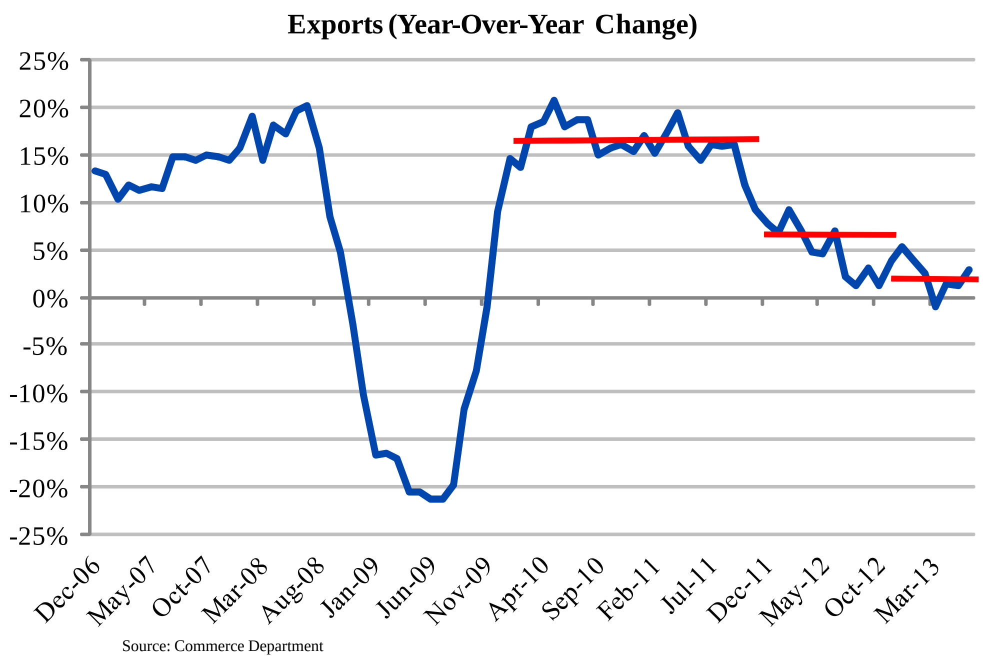
Production Trends have Stabilized, But Growth to Remain Slow





The post-recession economic and earnings snapback has played out. Production measures, like industrial production and exports, have stabilized in recent months after slipping earlier in 2013, but growth in these areas remains far below where it was earlier in the recovery.

Higher taxes and reduced government spending, along with less risk-taking, less leverage and better rationalization of credit, will dampen economic activity in U.S. in the environment ahead.

The economy will continue to grow, but many of the broad measures of the economic activity that we follow point to slow growth. In addition to the slower gains in industrial production and exports, the growth in hours worked, personal income and productivity have all diminished materially.

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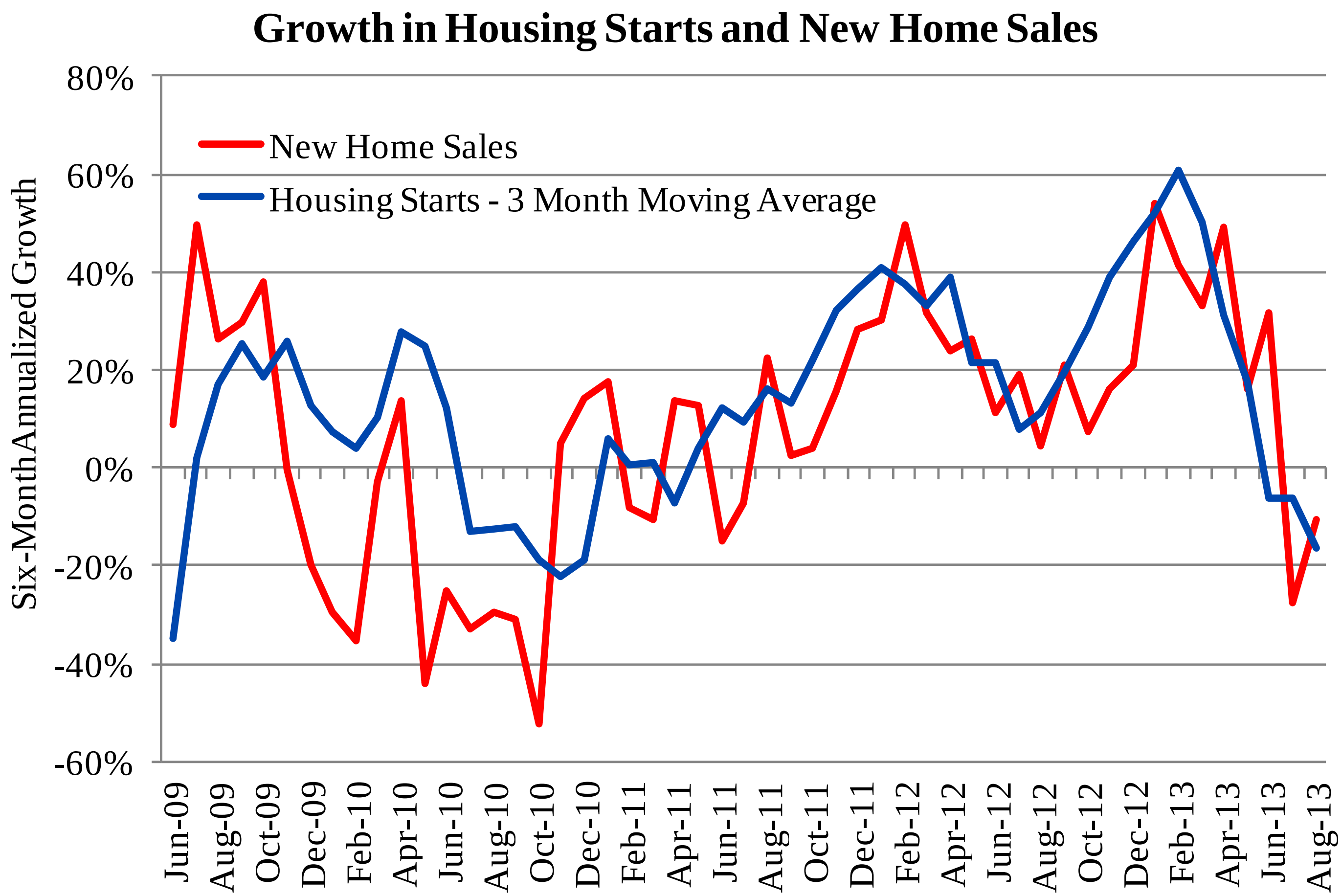
Housing Growth Rates Weaken Further



Source: Commerce Department

Growth has slowed in 2013 for a number housing related metrics. Housing Starts, for example, increased 19% for the twelve months ended August, but the category <u>declined</u> at a 16% annualized rate for six months ended August. We saw indications of plateauing activity earlier in the year, and that trend has persisted into the second half of the year.

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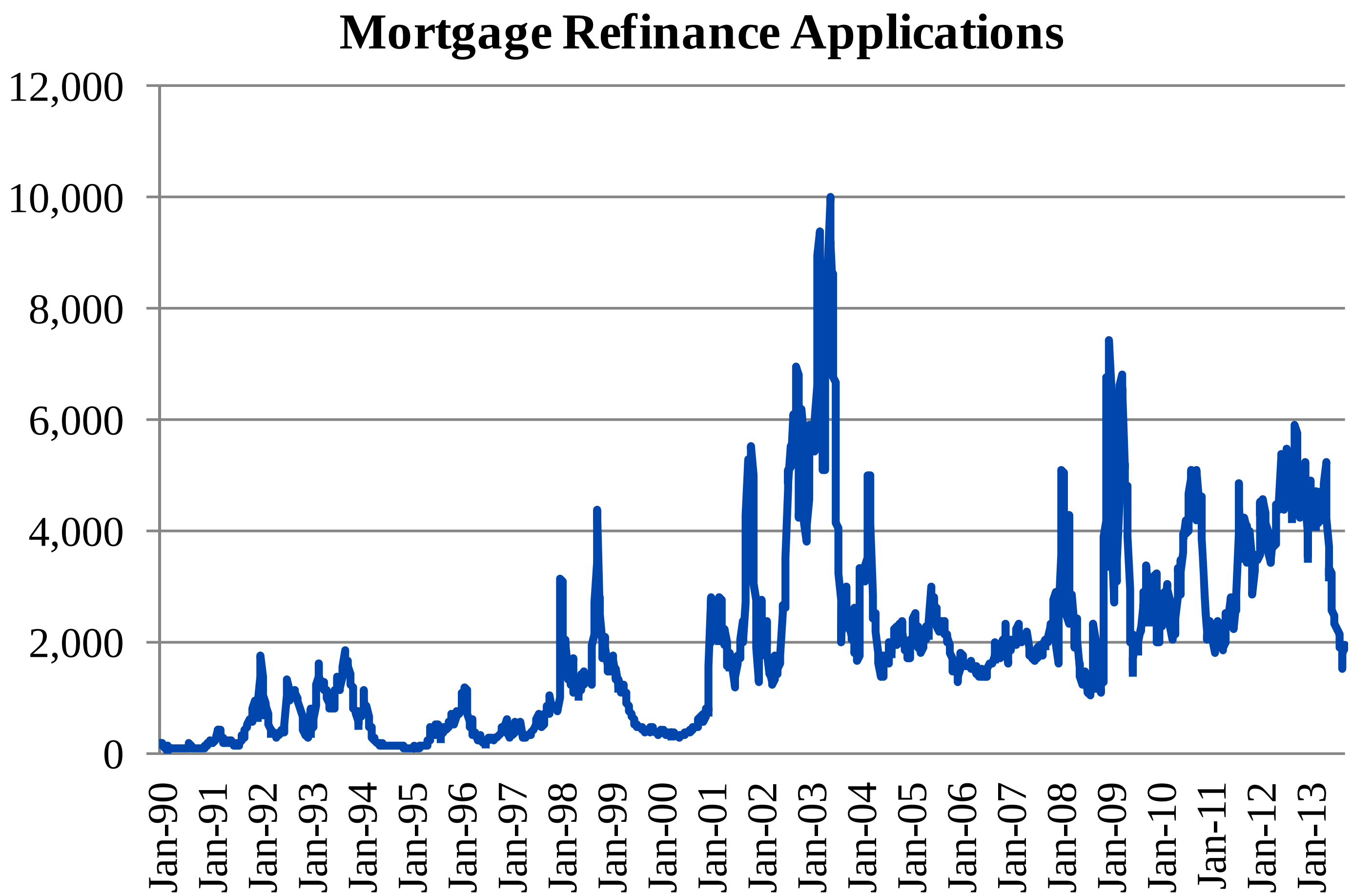
Lower Mortgage Applications are a Headwind for Financials



Source: Mortgage Bankers Association

Applications to refinance existing mortgages have fallen sharply as mortgage rates have increased. The interest rate on a 30-year fixed rate mortgage has increased nearly 100 basis points since May. The number of weekly refinance applications have fallen over 60% from the most recent high in May 2013. A drop in refis, along with legal costs, the rollout of more regulations and soft loan demand will all be headwinds to earning growth for Financials in upcoming quarters.

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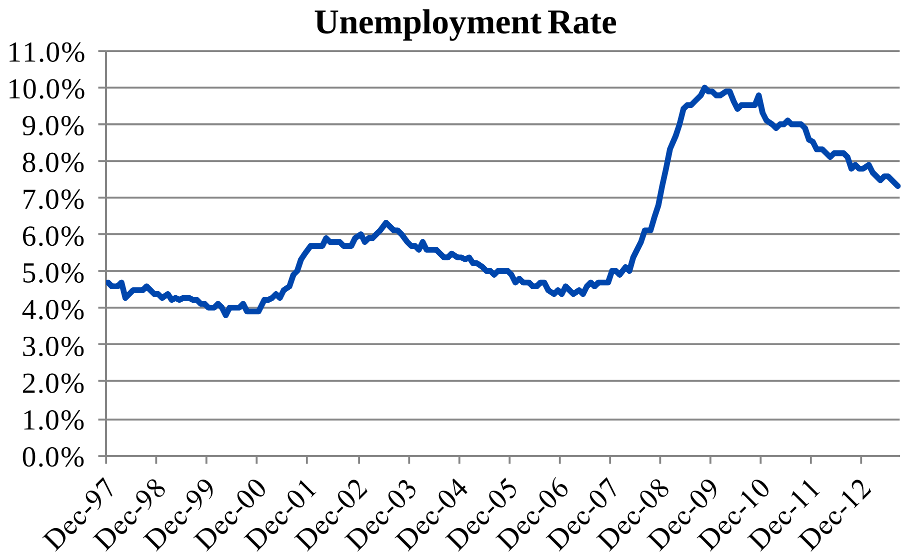
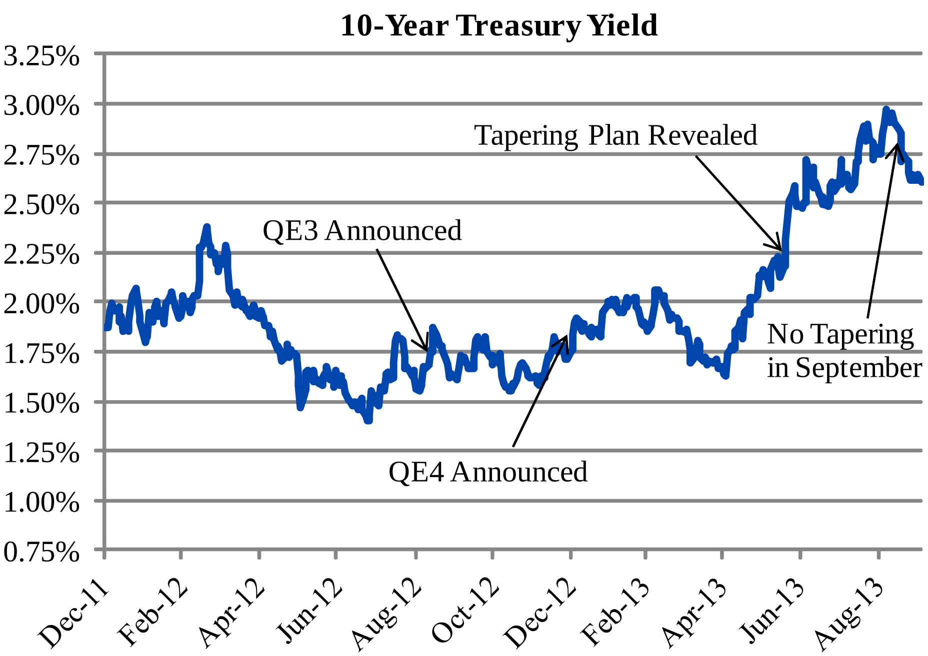
Fed Remains on the Path to Reduced Asset Purchases



Source: Bureau of Labor Statistics



Source: The Federal Reserve

The FOMC at its September meeting kept the pace of asset purchases at $85 million per month. The Committee cited improvement in "economic activity and labor market conditions," but said it "decided to await more evidence that progress will be sustained before adjusting the pace of its purchases."

We agree with the Fed's conclusion that the pace of economic growth is not strong. The Fed previously said that policy was data dependent, and they lived up to that claim. Their decision built credibility on the Committee's data dependency, but it also created confusion about the Fed's policy course ahead.

We believe the Fed remains on a path to reduce its extraordinary monetary policies, but the time table is uncertain. Nevertheless, the market is not focused on the exact timing of the Fed's moves, but instead is concerned with the direction of policy. This indicates that the decline in interest rates following the Fed's announcement will only be temporary. Interest rates should normalize as the market discounts less Fed manipulation of long-term interest rates.

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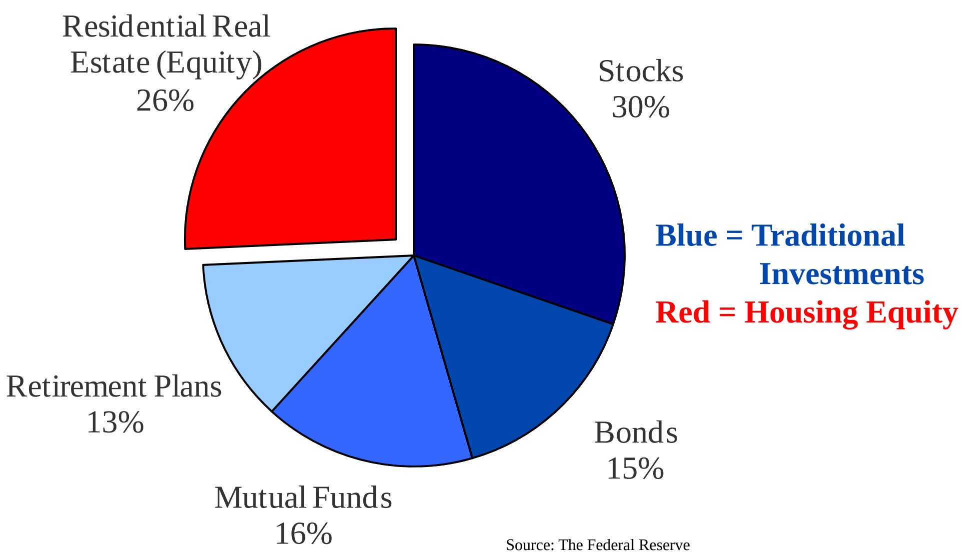
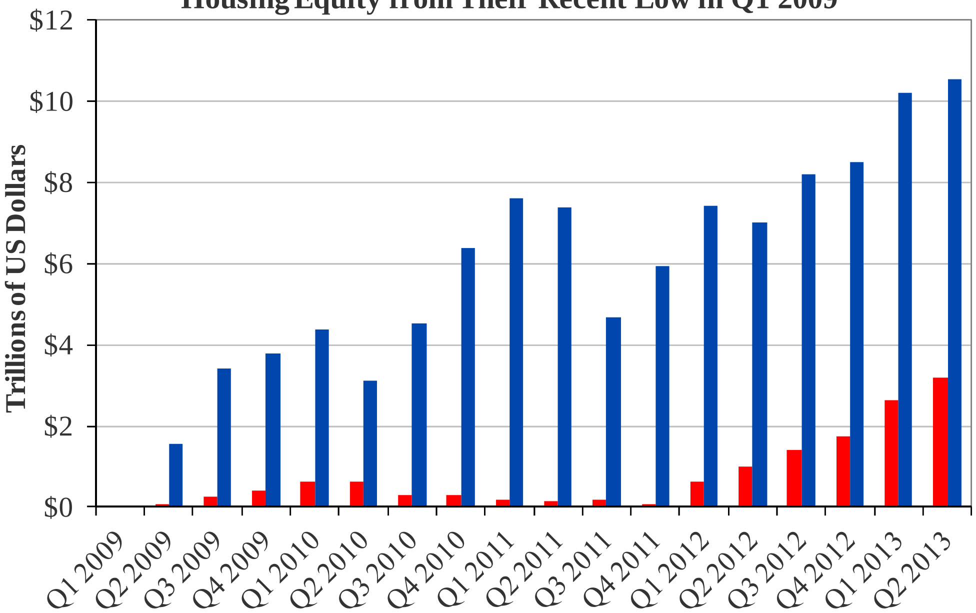
Traditional Investments are Key to the High-End Consumers

Household Investments (Q2 2013: $36.1 Trillion)



Source: The Federal Reserve

Increase in the Value of Traditional Investments and Housing Equity from Their Recent Low in Q1 2009



Source: The Federal Reserve

Housing is the largest investment for the typical American, but the value of traditional investments, like stocks and bonds, swamps the value of housing equity.

Traditional investments accounted for 74% of the value of individuals' investments as of the end of Q2 2013.

For the wealthiest Americans traditional investments dominate their net worth. These same wealthy Americans, who drive consumer spending, have seen the value of traditional investment increase by more than $10 trillion since their low in 2009.

The strong performance of traditional investments in recent years has contributed to strong spending growth by high-end consumers over the same period.

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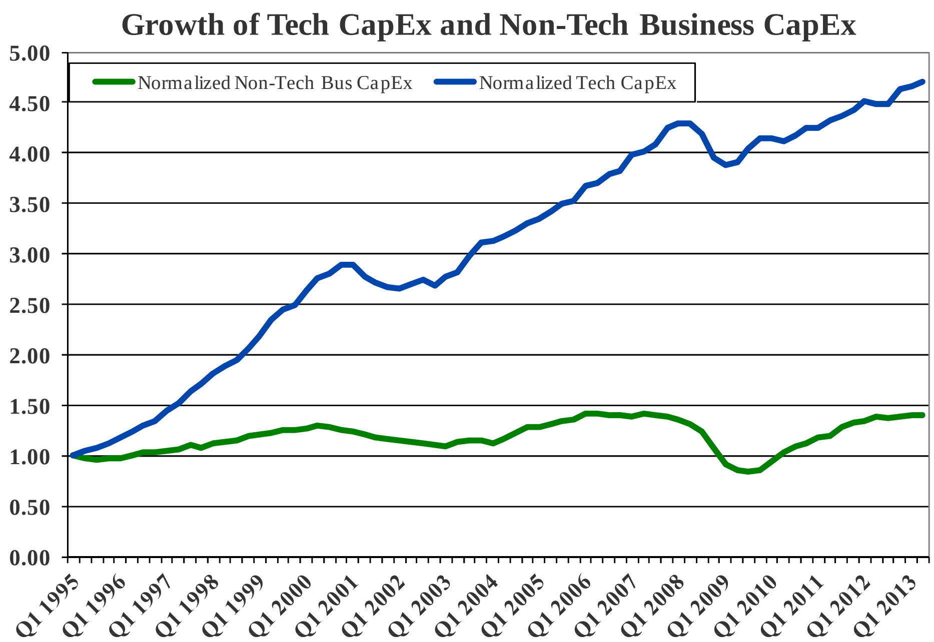
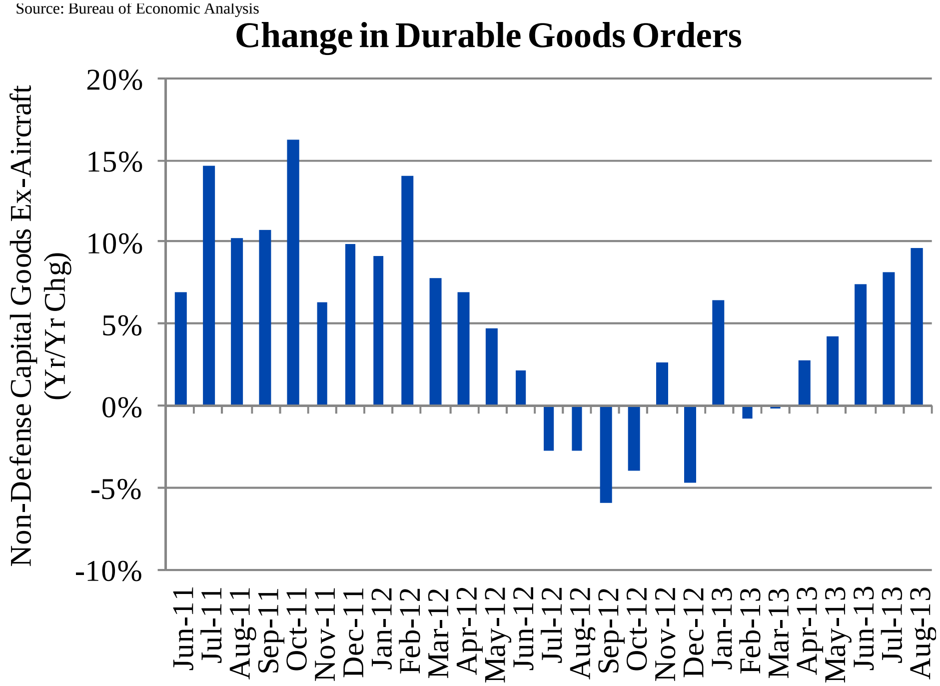
Tech CapEx Drives Broad Business Investment



Source: Bureau of Economic Analysis



Source: Commerce Department

Technology CapEx, which accounts for half of business CapEx, continues to be strong.

Tech CapEx made a new all-time high in Q2 2013 while Non-Tech Traditional Business CapEx is only now back to its previous peak.

CapEx on technology was very strong in Q4 2012 as tech spending added the most to GDP growth in four years, and tech spending increased further on a sequential basis in Q1 and Q2 2013.

Nondefense capital goods ex-aircraft orders, a proxy for business CapEx, have improved over the last nine months after weakness last year ahead of the Fiscal Cliff. Durable goods orders have improved, but shipments have not picked up to the same degree.

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