U.S. Economy Shows Its Maturity

The U.S. economic cycle appears to be maturing, as areas of economic strength continue to narrow and structural challenges to international growth persist. Slower growth looks to be the most likely scenario, with increased risks for the more economically sensitive areas of the market.

Investors who hoped the second quarter (Q2) would resolve some of the uncertainty facing the global economy and financial markets set themselves up for disappointment. The quarter ended up introducing more questions than it answered on both the direction of U.S. economic growth and the impact of structural challenges overseas. Broad stock market returns for the quarter were fairly muted, and interest rates fell globally.

U.S. equities, as measured by the S&P 500 Index, returned 2.46% in Q2. Investors seemed to grasp for the perceived certainty of directly observable factors last quarter, such as the rebound in oil prices and the decline in longer-term interest rates. This led to an unusual mix of S&P 500 sector leadership in Q2 as Energy, one of the most cyclical sectors, and Utilities, one of the least cyclical sectors, outperformed. Given our longer-term outlook for slow U.S. economic growth and the risk of rising interest rates, our portfolio positioning currently excludes both of these U.S. sectors, which weighed on performance during the quarter. We made portfolio adjustments to reflect anticipated changes in the economic backdrop, and we believe our strategies are positioned to perform well in the slow growth environment we expect.

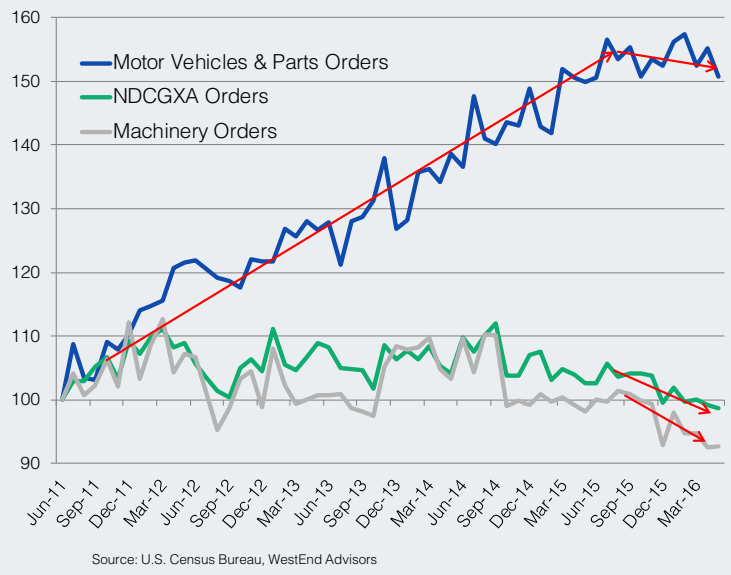
The biggest news internationally was, of course, "Brexit," as the U.K. voted on June 23rd to leave the European Union. The surprise British decision to exit (hence "Brexit") the economic and political union introduced uncertainty over the U.K.'s future relationship with major trading partners, and cast doubt over the prospects for both the euro currency and a cohesive E.U. The British pound fell more than 10% versus the U.S. dollar in a matter of hours following the Brexit referendum, and the U.K.'s FTSE 100 stock market index and other European stocks fell sharply when markets opened the following day. Japan's stock market also declined following the Brexit vote, but the yen (seen by some as a "safe haven" currency) rose sharply against both European currencies and the dollar. Uncertainty around Brexit's impact will remain for some time to come, but U.K. and European equity markets rebounded from post-Brexit lows by quarter end. The FTSE 100 actually returned over 6% for the quarter, as measured in British pounds, but was down almost 2% in U.S. dollar terms. Eurozone equity markets were down less than 3% for the quarter in euros, but down over 5% in dollars.

Meanwhile, low or negative interest rates around the world have limited policy options available to central banks. The U.S. Federal Reserve (Fed) has signaled its desire to raise the Federal Funds rate for several years, and did implement an initial 0.25 percentage point rate increase at the end of 2015. Since then, soft domestic economic growth, threats to growth from geopolitical issues overseas, and a lack of inflationary pressures have combined to forestall further rate hikes. The Fed recently signaled rates may remain lower for longer than we or the market previously anticipated, despite the apparent desire by policy makers to normalize monetary policy. The 10-year U.S. Treasury finished Q2 at a yield of 1.49%, down from 1.78% at the end of Q1 and near the lowest levels on record. Longer-duration bonds outperformed shorter-term fixed income in the quarter.

A Maturing Economic Cycle

We have noted in recent commentaries a narrowing of strength in the U.S. economy. The manufacturing sector is suffering from declining exports, with dual headwinds of weak international economic growth and the strong U.S. dollar. Figure 1 illustrates how orders for nondefense capital goods ex-aircraft (NDCGXA) have deteriorated over the past year as automobile orders turned lower and other categories, such as machinery orders, have fallen.

Figure 1: Durable Goods Orders



Source: U.S. Census Bureau, WestEnd Advisors

Consumers have been a key driver of the current economic expansion in the U.S., but recent data suggest consumer trends have softened and are being driven by fewer categories. Headline retail sales for June grew 2.7% year-over-year, but excluding the restaurant, online retail, and auto categories, retail sales rose just 1.1% year-over-year.

Gains in the labor market have slowed. The weak May payrolls figure was revised down further to only 11,000 with the release of June data. An addition of 287,000 payrolls in June was not enough to break the downward trend indicated by the measure's declining three-month average. The annual decline in the unemployment rate has also slowed, and growth in the use of temporary workers, which tends to be robust as companies expand early in the economic cycle, has slowed (see Figure 2).

Other broad measures of the U.S. economic environment suggest challenges to growth as well. Corporate profits, as measured by the U.S. Bureau of Economic Analysis, have been negative on a year-over-year basis for two quarters in a row through Q1 2016 (and for four consecutive quarters when adjusted for inventory valuation and capital consumption). The average number of hours worked each week by private sector employees has been below recent highs for the last five months, suggesting businesses' demand for labor has fallen. U.S. productivity gains also remain very low by historical standards (less than 1% year-over-year over the past six quarters). In addition, an increase in the business inventories-to-sales ratio could dampen production quickly as demand slows.

Growth of the Leading Economic Index© (LEI) has essentially stalled, as illustrated in Figure 3. The LEI combines a range of forward-looking indicators to forecast near-term economic trends, and it currently indicates slower economic growth ahead.

International risks to growth have also increased with the introduction of uncertainty surrounding the Brexit. The negative economic impact of the Brexit should be felt primarily in the U.K., but the magnitude of that impact is far from certain. If exit negotiations with the E.U. become contentious, either side might implement trade barriers, which would likely increase economic headwinds for both the U.K. and the E.U. (and fuel continued short-term market volatility). Alternately, if negotiations go smoothly, the U.K. might be able to retain, via treaty, many of the key economic advantages of the E.U. membership such as relatively free trade and open borders with the E.U. However, that could boost similar "separatist" movements in other E.U. countries. Either outcome could threaten the stability of the E.U and euro currency.

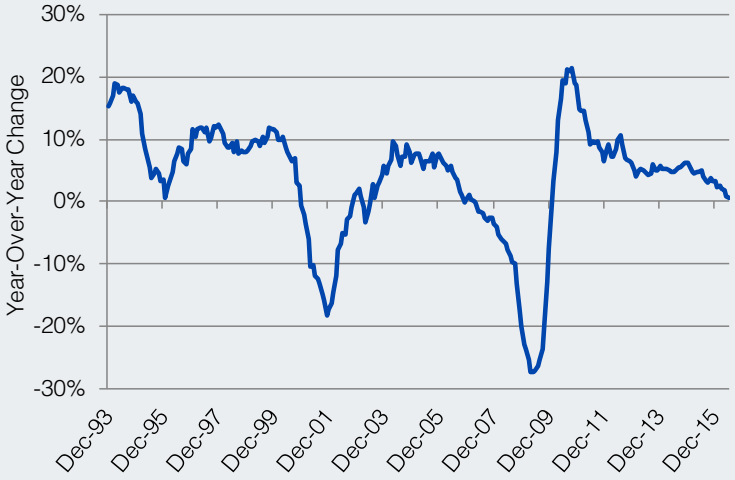
Brexit serves to underscore the broader structural challenges we have seen for some time for major foreign economies from Europe to Japan. In global portfolios, we continue to favor U.S. equity exposure over international developed equity markets. At the same time, we continue to evaluate the longer-term fundamental impact of the Brexit decision on economies around the world.

Adjusting to Slower Growth

We believe the U.S. economy is downshifting from the modest growth seen through much of the current expansion to even slower, less certain growth (a potential uptick in Q2 GDP growth not withstanding). This shift implies an increased risk of recession over the next six to eighteen months, though we believe slow growth is still the most likely scenario.

The slower growth we anticipate warrants greater exposure to sectors that are more insulated from cyclical swings, like

Figure 2: Temporary workers



Source: U.S. Bureau of Labor Statistics, WestEnd Advisors

Figure 3: Leading Economic Index©

Source: The Conference Board, WestEnd Advisors

Consumer Staples and Health Care. While the U.S. Consumer Staples Sector currently commands a premium valuation, relatively stable growth prospects within the sector offer attractive opportunities in the slow growth environment we anticipate. The U.S. Health Care Sector, on the other hand, currently trades at an atypically discounted price-to-earnings multiple versus the S&P 500, reflecting, in part, investor concerns over potential political interference in drug pricing. We believe the risk of such interference is low and has been discounted broadly across the sector by the market. The Health Care Sector, in our view, offers expected revenue and earnings growth that is among the highest of any sector.

The anticipated reliability of Health Care Sector revenue and earnings growth stands in direct contrast to more cyclical and economically sensitive sectors like Energy. While avoidance of U.S. Energy Sector exposure detracted from our portfolios' relative performance both in Q2 and year-to-date, we believe Energy is unlikely to sustain recent outperformance. The Energy Sector is now valued at over 30x estimated 2017 EPS, which is roughly twice the current forward earnings multiple for the S&P 500. From 2005 to 2014, the Energy Sector consistently traded at a discounted valuation versus the S&P, and typically below 12.5x earnings. Based on the relationship between oil prices and Energy sector earnings, our analysis indicates oil would need to double to around $90 a barrel to justify the current pricing of Energy stocks at a 12.5x multiple. We believe demand is unlikely to support such a price for oil in the slow growth environment we anticipate. As such, we continue to avoid the U.S. Energy Sector in portfolios.

We reduced portfolio exposure to the U.S. Consumer Discretionary and Information Technology Sectors in Q2. These sectors are subject to cyclical economic forces, and thus warrant smaller allocations as the economic cycle matures. However, they should still offer relatively attractive earnings growth opportunities in the slow growth environment we anticipate over the next six to eighteen months. We continue to avoid U.S. sectors with high economic sensitivity, including Industrials, Materials, and Financials, as well as Energy. We also continue to limit the interest rate sensitivity of portfolios. While we maintain a neutral view on equities versus fixed income compared to investors' benchmarks as the timing of a move up in long-term interest rates remains uncertain, the potential for rates to rise from multigenerational lows represents a material risk to longer-duration fixed-income securities. Thus, we believe investors should avoid the U.S. Utilities Sector in equity allocations and emphasize short-maturity securities within U.S. fixed-income allocations.

WestEnd Advisors Investment Team

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