Moderate economic growth in the U.S. provided little fundamental momentum for U.S. equities in 2016. Still, the S&P 500 produced a total return of 11.96% in 2016, with over half of its price appreciation coming in the final two months of the year, as stocks reacted positively to the U.S. election. This showed a stark contrast between investor enthusiasm following the surprise U.S. election results and actual 2016 economic results, with estimated full-year GDP only rising about 1.6% (Figure 1).

The year as a whole, and the fourth quarter (Q4) in particular, saw some dramatic shifts in U.S. sector leadership. Interest rate-sensitive sectors like Utilities and Telecom Services led early in the year, only to reverse as interest rates began to rise. Financials lagged most of the year, but returned over 20% in Q4 on post-election hopes that rising interest rates, deregulation, and resurgent economic growth would bolster earnings growth. Other economically-sensitive sectors like Industrials and Materials also outperformed following the election. Health Care was the only S&P 500 sector to post a negative return in 2016, as fears over political interference in drug pricing and uncertainty over the fate of Obamacare weighed on sentiment for the sector.

We see this shift from defensive leadership to economically-sensitive leadership as shorter-term variability within the larger economic and market cycle. Nevertheless, it made for a difficult environment for our economically-driven investment approach, and led to results well below our expectations and the long-term historical performance of our strategies.

Developments outside the U.S. were more in line with our forecast, as developed international markets generally underperformed the U.S. in 2016. The dollar rose against the euro and the British pound, presenting a further headwind for U.S.-based investors as economic uncertainty increased in Europe following the U.K.’s Brexit vote. Currency fluctuations for Asia and emerging markets were mixed, but a strengthening of the yen did little to offset the negative impact of Japan’s structural economic challenges.

U.S. fixed-income markets swung widely in 2016. Long-term U.S. Treasury bond prices rose steadily in the first half of the year as interest rates fell to record lows, with the 10-year Treasury rate dipping below 1.37% in early July. Those gains were wiped out in the back half of the year as interest rates surged following the U.S. election.

Outlook

U.S. Economy: We have recently revised our U.S. economic outlook, due, in part, to the outcome of the November U.S. elections. The likely introduction of pro-growth policies reduces the nearer-term risk of recession and could materially extend moderate economic growth. However, a significant reacceleration of economic growth is unlikely in our view. We also anticipate U.S. interest rates will continue to rise and bond prices will fall in the coming economic and political environment, particularly for longer-duration Treasury securities. The shift in our outlook warranted changes across our strategies to modestly increase the portfolios’ economic sensitivity and to reduce the interest-rate sensitivity of U.S. equity and fixed-income allocations, as detailed under Portfolio Positioning.

In the wake of the surprise U.S. election results, markets focused on the potential positive impacts of anticipated tax cuts, reduced regulatory burden, and fiscal stimulus under the new administration. Negative potential anti-trade and anti-immigration policies largely have been ignored. However, we expect the timing of the economic impact of pro-growth policies is likely to be more protracted than the market assumes because the budget process will likely bog down much of the Trump agenda. In addition, once legislated, it takes time to plan and implement stimulus, and to see the impact of regulatory reforms and tax cuts. Key cyclical engines that could power a resurgence

A Moderate Extension of the Cycle

Anticipated pro-growth policies in the U.S. may extend moderate economic growth, though a strong reacceleration is unlikely. We favor U.S. equity sectors with reasonably priced growth opportunities, while economically-sensitive sectors, yield-driven securities, and foreign markets face risks.
of growth have limited upside at this point following years of economic gains. Examples of the economic fuel that has largely already been burned include U.S. auto sales, which are above prior cyclical peaks, with record annual sales of 17.5 million units for 2016; as well as non-residential construction, which is in line with its pre-financial crisis peak, led by annual growth in office and lodging of 27.5% and 28.4%, respectively (Figure 2).

While markets seem optimistic about a reacceleration of economic growth, our analysis indicates that the potential incremental impact of new pro-growth policies might peak at about +0.5 percentage points of GDP growth in 2018. Plus, the near-term impact in 2017 will be even less because of the delayed implementation of new policies.

Our U.S. growth outlook has not shifted substantially, but there has been more change in our interest rate views. With unemployment down to 4.7%, hourly wage growth reached 2.9% year-over-year in December of 2016, which indicates increased inflationary pressures. Real interest rates, which compensate lenders for risks over and above inflation, have recently moved back into positive territory, but still have significant room to rise by historical standards (Figure 3). Additionally, the Federal Reserve is likely to continue normalizing short-term rates, pushing up the short end of the yield curve. All these factors indicate U.S. interest rates will continue to rise in 2017.

U.S. Equities – 2011 Redux?: The current post-election environment is reminiscent of the period from late 2010 to early 2011. Today, investors are anticipating potential Federal Government-led, pro-growth policies will be a catalyst for growth. In 2010, it was a second round of quantitative easing (supplemented by an extension of Bush-era tax cuts) that was widely perceived as reshaping the economic playing field and a catalyst for acceleration in growth. As Jack Willoughby, now a senior editor at Barron’s, noted in that magazine’s November 1, 2010 cover story: “Spurring stocks on…above all, [is] the likelihood that the Federal Reserve will make good on its promise to flood the financial system with fresh funds to stave off another recession.” The Federal Reserve even raised its own 2011 GDP growth estimates in February of 2011 to a range of 3.4% - 3.9%, up from a November 2010 forecast of 3.0% - 3.6%.

As hopes increased through the end of 2010 and into 2011 that another round of QE would deliver an economic reacceleration, the most economically-sensitive sectors materially outperformed. Energy, Materials, and Industrials were the top-performing sectors from Q4 2010 through Q1 2011, while sectors that are less reliant on an accelerating economy lagged, including Utilities, Consumer Staples, and Health Care. Yet, as 2011 wore on, economic data failed to support investor optimism (real GDP growth came in at a meager 1.6%), and market leadership shifted sharply to sectors with reasonably priced growth opportunities. Over the subsequent 12 months through the end of Q1 2012, Information Technology, Consumer Discretionary, Consumer Staples, and Health Care led the market, while the more-cyclical Materials, Industrials, and Energy Sectors lagged. We expect we could see a similar reversal of the recent rally in the most economically-sensitive sectors in 2017 if the economic results under the new administration fall short of expectations.

**Earnings and Valuation:** Current consensus earnings growth estimates for 2017 support the U.S. market’s overall P/E valuation, but risks to estimates are high for certain sectors. We believe valuations for many economically sensitive sectors have become over-extended in the post-election rally and present the greatest risk of delivering disappointing earnings growth and weak relative performance in 2017. For example, the Energy Sector’s recent rally and high valuation seem predicated on an unlikely sharp rebound in oil prices. OPEC’s agreement to cut production, which only goes through May 2017, could support oil prices in the $50 to $60 dollar range for a time, but current oil prices have limited upside at this point following years of economic gains.
Energy valuations, at about 33x 2017 estimated earnings, look like they are discounting another 50% or more increase in the price of oil in the near-term. Thus, even if oil prices go up in 2017, Energy stocks may still underperform as they grow into their lofty valuations.

In contrast, sectors like Health Care and Information Technology have secular tailwinds and specific catalysts for growth without relying on a major reacceleration of economic activity. They also trade at attractive valuations compared to the broad market. The Health Care Sector, for example, has traded at a premium P/E ratio versus the S&P 500 more than 70% of the time over the past quarter century. This reflects health care companies’ proven ability to deliver consistent, above-market earnings growth. Today, however, following a year of disparaging political rhetoric over drug pricing, the Health Care Sector trades at a 15% discount to the S&P based on 2017 EPS estimates. With favorable earnings growth potential in a moderate economic growth environment, Health Care should outperform as political uncertainty eases in 2017.

International Challenges Continue: Economic growth in Europe should remain slow in 2017 in the face of ongoing structural challenges. The U.K.’s surprise Brexit vote in June of last year may prove to be the leading edge of a populist wave across Europe, driven by anti-immigration and anti-globalization forces. For example, multiple candidates in France’s upcoming election support a “Frexit” referendum. Uncertainty surrounding economic and monetary union in Europe is likely to continue to weigh heavily on economic growth and markets over the next year; and yet, the European Central Bank seems likely to reduce monetary accommodation.

In the Asia/Pacific region, Japan continues to struggle to gain economic traction. The Bank of Japan remains accommodative, but appears unlikely to ease monetary policy further. China’s government will continue to manage its economic growth as it confronts its own structural challenges, moving only slowly toward increased market mechanisms. China and other emerging markets also face significant uncertainty over U.S. trade policy as well as risks from U.S. dollar strength.

Portfolio Positioning

Given our refined outlook, we are comfortable with some economic sensitivity in our strategies. Following the election, we increased the economic sensitivity of portfolios in anticipation of a more extended period of moderate growth. This adjustment included adding to our overweight of U.S. Information Technology, which should benefit from ongoing consumer demand and increased business investment in such an environment. We also maintain some economic sensitivity through exposure to the U.S. Consumer Discretionary Sector. We continue to avoid, however, U.S. sectors that are dependent on a strong economic reacceleration for earnings growth, including Industrials, Materials, and Energy.

While more economically-sensitive sectors showed strong momentum after the election, a disciplined investor needs to build portfolios in anticipation of the next favorable area of the market. These sectors’ Q4 momentum was based on expectations that we believe will be largely unmet. A notable exception, however, among sectors that rallied post-election is U.S. Financials. We see a more favorable fundamental picture for the Financials Sector in the environment ahead, supported by rising interest rates, continued economic growth, and lessening regulatory drag. Additionally, Financials Sector valuations do not appear as stretched as other economically-sensitive sectors, despite its market-leading performance in Q4. Thus, in the new year, we believed it was appropriate to initiate exposure to U.S. Financials. We also continue to overweight the U.S. Health Care Sector, which should benefit from healthy earnings growth and improving relative valuation in the environment ahead.

Looking more broadly at equity markets, an overweight of the U.S. markets versus Europe and Asia/Japan is warranted. While strong economic reacceleration in the U.S. seems unlikely, its moderate growth compares favorably against the economic malaise and structural challenges abroad.

Additionally, we continue to limit the interest-rate sensitivity of portfolios. We have avoided U.S. Utilities, and recently reduced U.S. Consumer Staples exposure and further shortened the duration of fixed-income allocations of balanced portfolios.

As always, we will continue to evaluate our outlook based on new information and analysis. At the same time, even as we face risks to our outlook, as all investors do, we are confident our portfolio positioning will be rewarded as investors come to terms with the realities of the post-election environment.

WestEnd Advisors Investment Team

January 17, 2017

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