Investors Feel Better, But real Change Takes Time

Investors refocus on fundamental growth opportunities as the political reality sets in – that a new administration's policies almost always fall short of the hopes, fears, and campaign rhetoric that surround them. Expect continued moderate economic growth in the U.S. and challenges abroad.

U.S. stock markets continued their post-election rally in the first quarter of 2017 (Q1) as investors aligned with our view that the risk of recession is less than it appeared in mid-2016. Within the continued stock market rally, however, U.S. sector leadership shifted markedly during the quarter. Many of the economically-sensitive market leaders in Q4 2016 (particularly post-election) lagged in Q1, including Energy and Materials. Meanwhile, Information Technology and Health Care, sectors with earnings growth opportunities that are less reliant on a material economic reacceleration, were leading performers in Q1. Investors who began to better appreciate that the timing and potential impact of pro-growth initiatives are less than certain are now focused on the fundamentals of a moderate growth reality.

Overseas, most equity markets also rose in Q1. Political factors in both the U.S. and internationally may have helped support international equities. Inflated fears of the negative impact abroad from U.S. trade policies have been easing, which has also likely boosted investor sentiment toward international equities, and particularly emerging markets. A modest decline in the value of the dollar also enhanced international equity returns for U.S. investors.

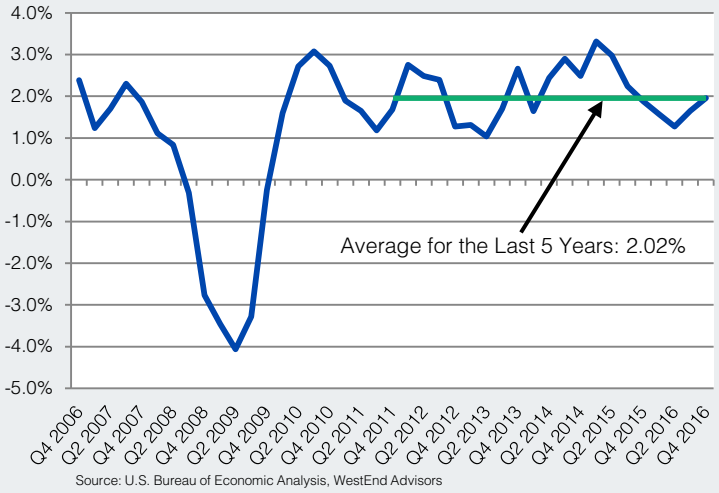
U.S. fixed-income markets traded in a relatively narrow range in Q1 compared to the volatility of Q4's post-election interest rate spike. The 10-year Treasury rate ended Q1 at 2.40%, down 5 basis points from year-end, even as the Federal Reserve (Fed) moved forward with its second Fed Funds Target Rate hike in three months (the third hike this cycle) and signaled for more rate increases later this year.

Outlook

U.S. Backdrop: Real GDP growth in the U.S. has trended around 2% since 2010, as illustrated in Figure 1. We believe this prolonged period of slow expansion has gradually released pent-up economic demand since the last recession, much like a slow expansion of a compressed spring. This has reduced the potential for a powerful expansion ahead. While the new administration's potential pro-growth policies will likely reduce the near-term risk of recession, we still see no catalyst for a material sustained reacceleration of the U.S. economy, and we expect moderate economic growth to continue.

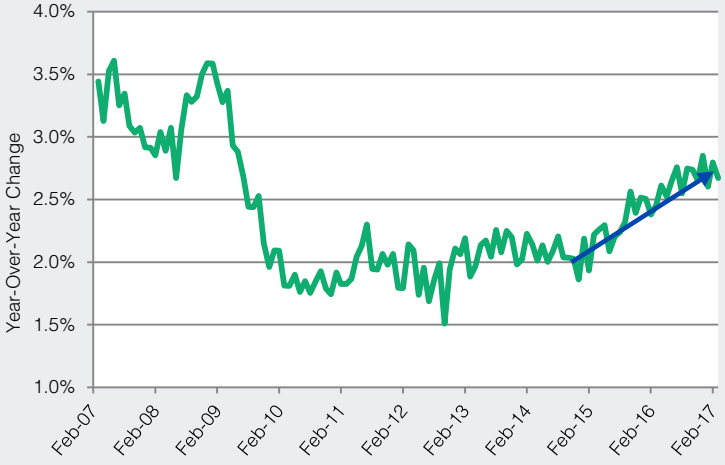
We also anticipate the extended period of moderate economic growth to be accompanied by rising inflation and higher interest rates. Nearly eight years of slow economic growth with limited productivity gains (by historical standards) have significantly reduced slack in the labor markets. The resulting wage inflation can put upward pressure on broader inflation measures and, in turn, longer-term interest rates. Meanwhile, the Federal Reserve's attempt to normalize monetary policy places upward pressure on shorter-term interest rates. Additionally, *real* interest rates (the spread between nominal interest rates and inflation) remain at essentially zero. While low real rates are common early in an economic recovery, real rates have persisted at these levels for close to a decade. The combination of rising inflation, Fed monetary policy normalization (i.e. rising short-term rates), and a potential return to positive real interest rates could drive up rates across the yield curve as the economic expansion continues.

Figure 1: U.S. GDP (Year-over-Year)



Source: U.S. Bureau of Economic Analysis, WestEnd Advisors

Figure 2: U.S. Hourly Wage Growth



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

The Q1 shift in U.S. sector leadership may have been the result of political reality setting in. No president has ever been able to fully realize his policy aims. Checks and balances exist even when one party controls the White House and Congress. This is already evident with the new administration's recent failure to repeal and replace Obamacare. Further, as we have noted in recent commentary, even when pro-growth policies do pass, they always take time to implement. Thus, we anticipate political hopes and fears that distracted from economic fundamentals will likely continue to fade, and U.S. equity investors will refocus on earnings growth opportunities in the coming quarters.

Sector Opportunities and Risks: In the fundamental environment we anticipate, one sector in which we see new opportunity is U.S. Financials. While we typically view the Financials Sector most favorably in a rapidly expanding economic environment, we also analyze and account for differences from one market cycle to the next. The current cycle has been characterized by modest economic growth and increasing regulatory headwinds for Financials, largely in reaction to the 2008 financial crisis. We believe a further extension of moderate economic growth, combined with a reversal of regulatory headwinds, should materially benefit the Financials Sector. Increased confidence in the durability of the expansion, along with potential tax changes, should support growth in lending and increased merger and acquisition advisory activity. A less constraining or oppressive regulatory environment, with fewer restrictions on lending, trading activities, and how banks invest their capital, should allow for enhanced revenue growth and profitability for major financial firms. Additionally, rising interest rates could provide a boost to bank profitability, as many banks' existing loan rates adjust with higher short-term interest rates.

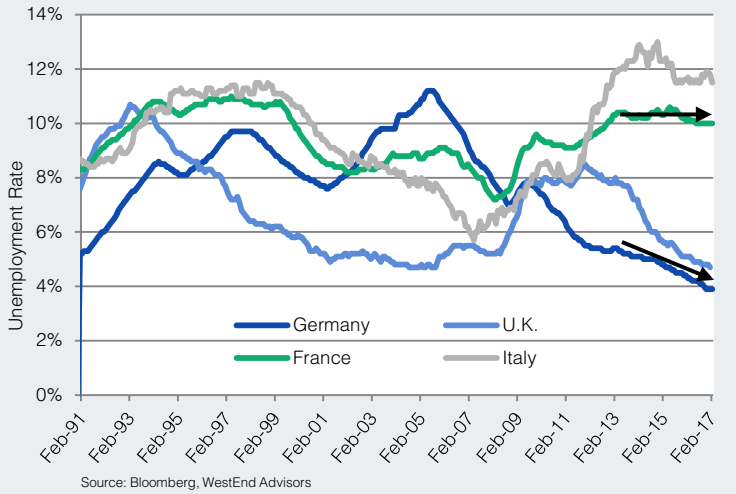
Looking at the U.S. market as a whole, we remain skeptical of double-digit earnings-per-share (EPS) growth forecasts. Analysts' S&P 500 EPS estimates for 2017 are heavily skewed by the Energy Sector. Energy Sector 2017 EPS growth estimates of roughly 300% account for over three percentage points—nearly a third—of the expected earnings growth for the S&P 500. We have been cautious on the outlook for the Energy Sector and oil markets for some time. Risks to the sector include a combination of modest oil demand growth, potential U.S. dollar strength, and an increased supply response to rising oil prices. Our analysis suggests Energy Sector earnings estimates and valuations continue to price in significantly higher oil prices, which seem unlikely in the near-to-intermediate term. So far in 2017, our view that the Energy Sector will fall short of expectations appears to be playing out.

We continue to expect U.S. sectors that are not highly dependent on economic reacceleration to drive earnings growth will outperform. The Information Technology and Health Care Sectors, in particular, have strong secular fundamentals that should support attractive earnings growth, even in the moderate economic environment ahead. Information Technology should benefit from continued adoption of cloud computing and online advertising. Potential corporate tax law changes could also spur increased demand for enterprise technology investment and repatriation of overseas capital, which could be deployed for additional investments in growth or for shareholder-friendly measures such as share repurchases and dividend increases.

The Health Care Sector is heavily weighted to pharmaceutical, biotechnology, and medical device companies, which should show attractive earnings growth tied to new drug innovation and device roll-outs. The recent failure by Republicans to repeal and replace the Affordable Care Act (ACA) does not change these longer-term fundamental tailwinds, and may also prove to be a near-term positive for the sector, as preserving the status quo keeps a larger number of incremental patients insured. Uncertainty remains about the ultimate fate of the ACA—Republicans' stated willingness to "let it explode" may prove to be a self-fulfilling prophecy—but the debate around repeal suggests that many of its key provisions are too popular to be excluded from whatever form a replacement may take. Health Care currently trades at an atypical valuation discount versus the broad market. We believe this fact, coupled with the sector's stable earnings growth, presents one of the most attractive return opportunities in the environment ahead.

International Backdrop: Looking at overseas investment opportunities, we see structural and cyclical challenges as continued headwinds for developed markets. While Europe recently has seen modest improvement in the trajectory of its major economies, some key European countries are not fully participating in the improved economic conditions. France, Italy, and Spain, for example, have unemployment rates above 10%. These high unemployment rates point to the cyclical and structural challenges in each of these countries, even as Germany's and the U.K.'s unemployment rates are at all-time lows, as illustrated in Figure 3. The region also continues to face risks from a potential reduction in monetary accommodation by the European Central Bank, headwinds from regulatory bureaucracy, the impact of Brexit, and uncertainty around elections in France, Germany, and Italy over the next year.

Figure 3: Key European Unemployment Rates



Source: Bloomberg, WestEnd Advisors

Export economies around the globe, particularly among emerging markets, face risks from potential anti-trade policies in the U.S. and potential currency headwinds from dollar strength and rising U.S. interest rates. Japan's economic growth remains muted as household consumption, which represents about 60% of Japan's GDP, remains nearly flat (e.g. only 0.04% quarter-over-quarter in Q4 2016). While we do not see near-term catalysts that could lead to a dramatic change in our outlook overseas, we continue to evaluate the relative attractiveness of evolving opportunities across regions.

Outlook Summary: Overall, economic and political developments in the U.S. appear to be tracking largely as we expected, with continued moderate growth and an easing of the extreme hopes and fears investors harbored over the new administration. This environment should benefit areas of the market offering reasonably-valued growth opportunities, as was evident in the shift in U.S. sector leadership from Q4 to Q1. While risks and uncertainty remain—regarding policies to come from the Trump administration, the interest rate environment, and Fed policy—our overall view remains positive for U.S. equities, which compare favorably to foreign markets.

Portfolio Positioning

We continue to believe investors will refocus on earnings growth opportunities as they see a greater likelihood of an environment of extended moderate economic growth in the U.S. As such, we maintain material overweights to the Health Care and Information Technology Sectors within U.S. large-cap equity allocations. We continue to avoid the most cyclical and economically-sensitive U.S. sectors, including Energy, Materials, and Industrials. We added exposure to U.S. Financials during the quarter. This move reflects our confidence in the likelihood of financial regulatory reform, reduced risk of recession, and our expectations for rising interest rates and increased capital markets activity. All of these factors should provide the potential for U.S. Financials to perform well, even after their strong rally in Q4.

We also reduced the expected risk to portfolios from rising interest rates in Q1. We trimmed U.S. Consumer Staples equity exposure in order to fund, in part, our addition of Financials exposure. For portfolios with fixed-income allocations, we reduced exposure to fixed-coupon, short-term corporate securities and added exposure to a mix of short-duration Treasury Inflation Protected Securities, or "TIPS," and floating-rate corporate securities. The floating-rate securities have a duration of close to zero because their yields move with interest rates. These adjustments were designed to manage interest-rate risks, particularly as we believe that economic progress and government policies will lead to increased short-term interest rates as well as higher inflation.

Our positioning in international equities was essentially unchanged in Q1. We continue to underweight international markets due to their ongoing cyclical headwinds, structural challenges, and the relative attractiveness of sector opportunities in the U.S. equity markets.

WestEnd Advisors Investment Team

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