Rising Above Modest Circumstances

Modest economic growth continues globally, even as we see little potential for acceleration. Seek opportunity in areas of the markets with cyclical or secular growth drivers and reasonable valuations.

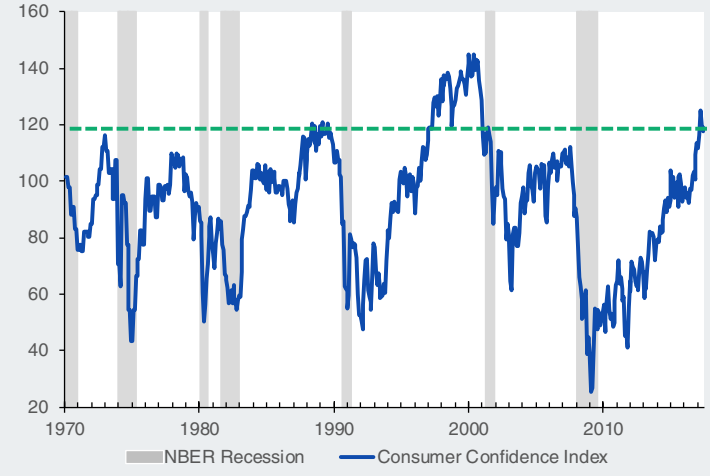
Q2 2017 Review

Global equity markets continued to post gains in the second quarter of 2017 (Q2), led by overseas equities and select U.S. sectors. U.S. Health Care and Information Technology, two sectors with relatively stable and strong earnings growth drivers, outperformed along with the highly-cyclical Industrials and Materials Sectors. Meanwhile, the Energy and Telecom Services Sectors declined for a second consecutive quarter as oil prices declined and mobile phone plan price competition heated up.

European equities led among developed markets in Q2 for U.S.-based investors, thanks to a higher euro versus the U.S. dollar. Europe benefitted from greater confidence about European Union stability as France elected Emmanuel Macron to be its next president. Emerging market equity returns were widely varied, but outperformed the U.S. and developed markets on average.

Economic data released in Q2 generally underscored our outlook for a continuation of modest economic growth in the U.S., rather than a reacceleration or downturn. In the U.S., consumer spending remains a key driver of economic growth, but has slowed somewhat in 2017. Industrial production growth, while slightly improved in recent months, remains moderate. Employment gains picked up somewhat in Q2, but remain lower, on average, in 2017 than in 2016. Internationally, economic growth has picked up a bit in some regions, like Europe, but even so, it remains modest for an expansion.

Figure 1: Consumer Confidence Index



Source: Bloomberg, The Conference Board, WestEnd Advisors

The U.S. Treasury yield curve flattened slightly in Q2. Intermediate and longer-term Treasury rates fell, on balance, while the Federal Reserve (the Fed) continued to push up short-term rates with another widely-anticipated quarter-point rate hike in June. The Fed's continued tightening came despite a downtick in inflation, which Fed Chair Janet Yellen dismissed as driven by temporary factors such as the reintroduction of unlimited data plans by major wireless carriers. As we discuss in our outlook, we too believe upward pressure on inflation will resume as constraints we expect to limit growth, like a tight labor market, should also drive up prices. Longer-term interest rates did begin moving higher again as the quarter ended.

Outlook

U.S. Expansion Plods Along: After years of unexciting growth, forecasting continued modest economic growth runs the risk of sounding like a broken record. While we see some shifts in the underlying details, our overall outlook continues to be for ongoing modest economic growth in the U.S. We do not see any likely catalysts for a near-term recession in the U.S., but the progress that has been achieved over this extended expansion leaves little room for a material reacceleration of growth.

The U.S. labor market has continued to tighten in recent months. A slight pickup in nonfarm payroll gains in Q2 helped push the unemployment rate below 4.5% throughout the quarter, even though average monthly payroll gains of 180K remain below the 2016 pace of 187K. Meanwhile, job openings reached an all-time record of nearly six million in April, according to the Labor Department, before slipping back some in May. This suggests companies are having increased difficulty finding appropriately skilled workers to fill positions. With the unemployment rate at 4.4% in June, it is likely companies will need to offer higher wages to compete for employees or draw additional workers back into the workforce. This acts as both a constraint on growth and a potential source of inflation pressures.

Various economic sentiment indicators rose following the 2016 election and remain elevated, including, for example, The Conference Board's Consumer Confidence Index and the Institute for Supply Management's Manufacturing Purchasing Managers Index. In fact, Consumer Confidence is now in line with or above peaks reached in the 1970s, 1980s, and 2000s (see Figure 1). Despite improved *sentiment* readings, however, measures of economic *activity* like GDP, Industrial Production, and payroll gains have been mixed, providing little indication of a change in the recent pace of economic growth.

We still expect some tax reform and other pro-growth policies will be implemented by the current administration and Congress, which need to deliver some results prior to the 2018 elections. This could mitigate some of the constraints on growth. We also continue to believe these policies will be implemented more slowly and have less economic impact than the initial post-election market rally of highly-cyclical sectors seemed to imply. Reversals of Q4 2016 sector leadership so far this year suggest investors are coming around to this view.

Key U.S. Sectors: As the U.S. economic expansion continues, the market environment should favor sectors that have some degree of economic sensitivity coupled with positive secular growth drivers. The Information Technology Sector, for one, is broadly benefitting from the continued migrations to cloud computing, digital advertising, and mobile payments. These trends are supported by technological advances as well as changes in both corporate and consumer behavior that favor operational efficiencies and personal convenience. As such, they are somewhat independent of the economic cycle and, thus, can drive above-average growth in a tepid economy.

Health Care is another sector with broadly positive secular trends that provide stable, attractive earnings growth potential. Yet, while the Health Care Sector has historically traded at a premium valuation to the broad market, it has been at a material discount since early 2016 amid concerns over the political climate for health care reform and drug pricing. The sector rallied sharply in late Q2 as the leak of a draft executive order suggested fears of heavy-handed drug price regulation were misplaced. This illustrated Health Care's significant outperformance potential given its combination of strong fundamentals and discounted valuation. The sector remains at an atypical discount to the broad market, despite its recent rally, and we see catalysts for continued outperformance as political uncertainty is further reduced. It now appears changes to the Affordable Care Act will be incremental on most fronts, providing a more stable regulatory environment for Health Care companies. The sector's performance could be headline-driven at times, but should increasingly reflect its positive fundamentals.

In contrast to sectors with strong secular tailwinds, the Energy Sector presents weak fundamentals and a premium valuation on expected earnings. Returns for the sector were negative in Q2 and YTD. Declining share prices have done little to bring Energy valuations back in line with their historical norms, as stock prices merely mirrored declining earnings expectations (see Figure 2). The Energy Sector trades at a P/E of about 30x consensus 2017 earnings estimates, an elevated valuation that seems dependent on an unlikely reversal of oil price fundamentals.

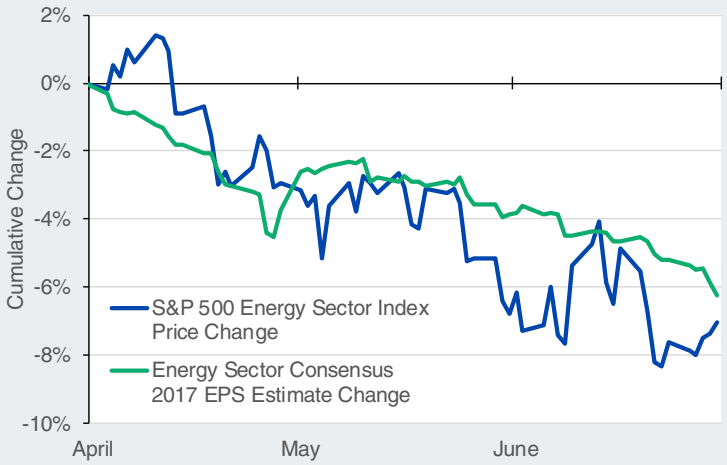
Fundamental trends in the Consumer Discretionary and Consumer Staples Sectors are more mixed. Reasonably stable personal income growth is providing a moderate economic tailwind for consumers, but shifting spending patterns, such as growth in online shopping, can create winners and losers among consumer-focused companies. Our allocations to these sectors (as well as to Technology, which also benefits from consumer trends), take these dynamics into account.

U.S. Inflation and Interest Rates: Inflation, as measured by the Consumer Price Index (CPI), slowed in Q2, due to what we believe to be temporary factors. These include a renewed downturn in oil prices and an acceleration of price competition among wireless telecom service providers. While items like mobile data plans may seem inconsequential in the context of broad economic trends, the cost of wireless service in the CPI fell more than 13 percent year-over-year as of June following widespread reintroduction of "unlimited" data plans. This, alone, shaved about two-tenths of a percentage point off of CPI inflation over the past year.

Setting aside temporary factors, we anticipate that wage pressure from the tightening labor market should support at least moderately higher inflation. This, in turn, should put general upward pressure on interest rates. Meanwhile, Federal Funds Rate hikes should push up short-term interest rates, and the Fed's plan to begin unwinding its long-term Treasury and mortgage bond holdings should provide incremental support for higher long-term rates.

The expected interest rate environment has implications for various U.S. equity sectors. For example, Financials Sector profits should benefit from banks' floating rate loans as short-term interest rates rise in an extended period of modest economic growth. Major banks are already better-positioned from a regulatory capital and credit exposure standpoint than at any time over the past decade. Plus, they are also facing a less hostile regulatory environment. Alternately, rising rates are a significant risk for the Utilities and Real Estate Sectors. Higher rates can be a blow to valuations for these traditionally high-yielding sectors, as bond yields become relatively more attractive to income-focused investors.

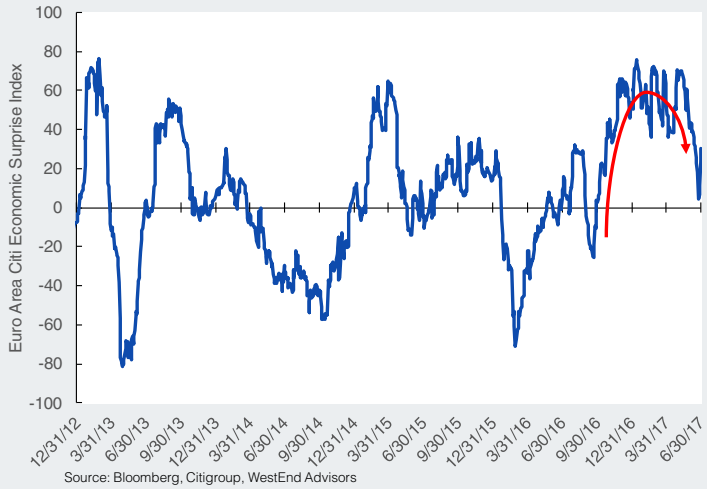
Figure 2: S&P 500 Energy Sector In Q2 2017



Source: Bloomberg, WestEnd Advisors

International Markets: Our views on the international economic picture and equity markets are little changed from recent quarters. In Europe, for instance, intermediate-term structural challenges and uncertainty remain. This is despite a recent boost in sentiment tied, in part, to the French election's perceived implications for EU/euro stability. Economic growth has also improved marginally in Europe, and is now roughly in line with the U.S. Nevertheless, we see even less opportunity for incremental improvement in Europe than in the U.S. going forward, absent major changes in structural factors such as labor practices. Meanwhile, higher expectations leave room for investor disappointment even with improved economic performance. Note that European economic data generally surprised to the upside earlier in the year, but positive surprises have moderated as sentiment improved and data has softened (see Figure 3). Additionally, the head of the European Central Bank (ECB), Mario Draghi, has hinted that the ECB might end or even reverse its quantitative easing efforts. This could present a headwind for the economically-stratified Eurozone.

Figure 3: Euro Area Citi Economic Surprise Index



Source: Bloomberg, Citigroup, WestEnd Advisors

Emerging markets have also seen an apparent boost in sentiment in recent months. Improved economic sentiment for developed markets and an easing of concerns over likely U.S. trade policy seem to have translated into increased expectations for emerging market economic growth. However, as previously noted, we believe developed market economic growth is unlikely to reaccelerate materially from current levels. Nor is the current global environment likely to produce commodity price strength or sustained weakness in the U.S. dollar that could benefit emerging market economies and drive outperformance of emerging market equities.

Portfolio Positioning

Given our outlook for continued modest economic growth in the U.S., we remain focused on areas of the U.S. market with positive growth trends and attractive valuations. Specifically, we remain materially overweight to the Health Care and Information Technology Sectors within U.S. large-cap allocations. Additionally, allocations to the Consumer Discretionary and Consumer Staples Sectors provide exposure to consumer spending, a key component of U.S. economic growth, while an allocation to Financials should benefit from regulatory trends and help limit risk to portfolios from rising interest rates. We continue to avoid the U.S. Energy Sector, the economically-cyclical U.S. Materials and Industrials Sectors, and interest rate-sensitive sectors such as Utilities and Real Estate.

In global portfolios, we remain overweight U.S. equities, and underweight international equities. While current economic growth rates are roughly comparable across the U.S. and many other major developed countries, we see greater structural risks to growth in Europe and Asia. Conversely, there are more potentially positive economic catalysts in the U.S., as well as enhanced opportunities in select U.S. equity sectors.

For portfolios with fixed-income allocations, we continue to emphasize short duration securities and select securities that provide relative insulation from rising rates, such as TIPS and floating-rate corporate securities.

Portfolios have generally benefitted from our macro-driven decisions so far in 2017, but, as always, we continue to look for opportunities to improve strategic and tactical positioning as the global economic environment and market conditions evolve. We look forward to providing additional updates as the year progresses, and we welcome any questions you may have about our investment process, outlook, or positioning.

WestEnd Advisors Investment Team

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