Calm Surface, Shifting Undercurrents

Broad market indices have shown little volatility of late, echoing slow-but-steady global economic growth that we expect will continue. Mercurial investor focus, however, has led to intermittent swings in market leadership. Investors should look to fundamentals to navigate this late cycle expansion.

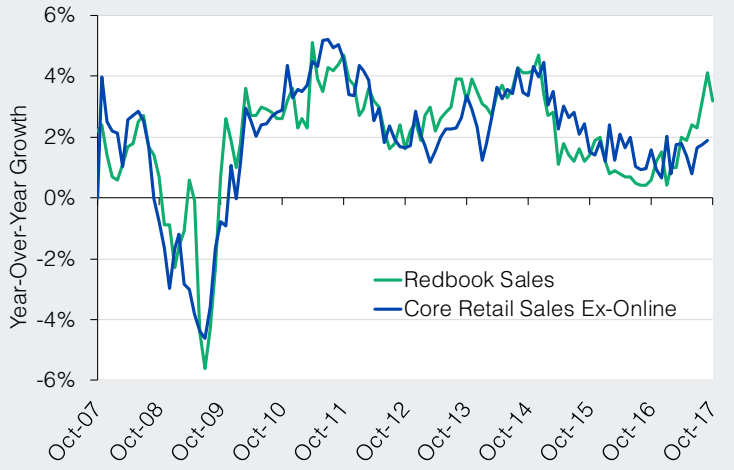
Q3 2017 Review

Stocks rose for an eighth consecutive quarter in the third quarter (Q3) of 2017, as economic data suggested ongoing modest expansion in the U.S. and globally. With Q3's positive returns, global equities as measured by MSCI ACWI have returned 17.25% year-to-date (YTD) in U.S. dollar terms. While international markets have led, U.S. equities, as measured by the S&P 500, still have provided a 14.24% return so far in 2017.

While overall equity market volatility recently reached record lows as measured by the CBOE Volatility Index, there have been significant swings in sector leadership this year, including in Q3. Technology, for example, led in Q3 and remains the best performing sector YTD, but underperformed materially in September. In contrast, Energy was the second-best performing U.S. sector in Q3, but the worst performer over the first two months of the quarter and YTD. Yet, the Energy Sector's 2018 P/E multiple is still at a 50% premium to the S&P 500. Financials outperformed slightly in Q3 due almost entirely to its own rally in September. Consumer Staples and Discretionary were the worst performing U.S. sectors in Q3 amid investor uncertainty over disruption from shifting consumer behavior.

Emerging markets led performance among international equities in Q3. European equities outperformed U.S. equities in U.S. dollar terms due to strength of the euro and pound, but underperformed in local currency despite improving sentiment and modest economic gains. Japan underperformed in both local currency and U.S. dollar terms.

Figure 1: Traditional Retail Reaccelerates



Source: Johnson Redbook Service, U.S. Dept. of Commerce, Bloomberg, WestEnd Advisors

Longer-term Treasury yields fell to start the quarter as inflation readings moderated (due to what we and the Federal Reserve believe to be temporary factors) and tensions escalated with North Korea. Interest rates rebounded in September, however, as inflation showed signs of reaccelerating and as geopolitical fears eased. This left rates virtually unchanged for the quarter.

Outlook

Our global economic outlook is little changed, despite noise in U.S. economic data from recent hurricanes. Real U.S. GDP growth is estimated to be 2.6% for Q3 (at a seasonally adjusted annualized rate). That equates to growth of 2.2% year-over-year, in line with both Q2 and the longer-term trend of this expansion.

The consumer remains a primary driver of U.S. economic growth. Payroll growth has been healthy this year, averaging an increase of 178,000 new jobs a month through August (the Bureau of Labor Statistics reported that September data was materially distorted by hurricanes Harvey in Texas and Irma in Florida, a temporary phenomenon likely to reverse in October). While job growth has slowed somewhat, which is to be expected this late in the cycle, layoffs are low and job security among workers is high. Overall consumer spending continues to grow at about 4% year-over-year, in line with its average throughout the current expansion.

Consumer Sector Exposure:

We believe continued exposure to the consumer – a key driver of growth – via Consumer Discretionary and Staples allocations is warranted.

While the consumer remains on solid footing, uncertainty over the long-term impact of the shift toward increased online distribution of goods, services, and media content has weighed on consumer-related sectors this year. However, as illustrated in Figure 1, we see signs of stabilization in traditional brick-and-mortar retail. The weekly Redbook report, which tracks traditional retail activity, has shown significant reacceleration in recent months. There will be winners and losers in both brick-and-mortar and online retail, but investor sentiment has become too dismissive of overall consumer strength, in our view. Mixed corporate and industry fundamentals reflect shifting consumer behavior more than overall weakness, and we continue to believe exposure to the consumer—a key driver of growth—is warranted.

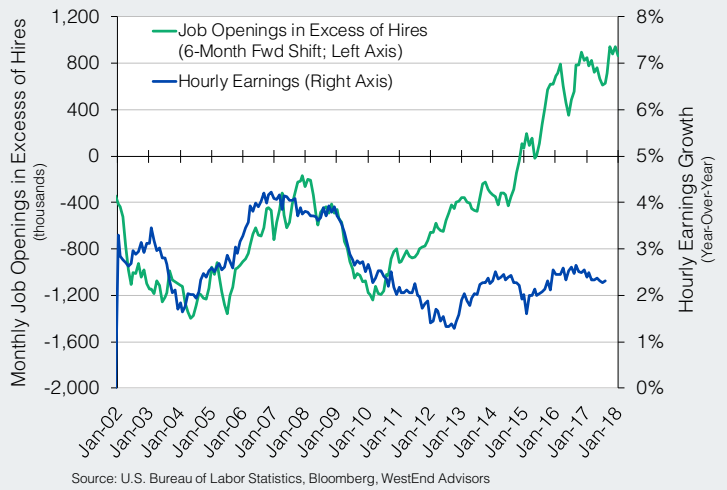
While we expect the economic expansion to continue, we also doubt we will see a material acceleration of growth. Given the economic progress that has already been made this cycle, for example, with the unemployment rate down to 4.2% and a rebound in auto sales to an annual rate above 18 million, the potential fuel for reacceleration of overall economic growth remains limited. We do, however, expect modest economic growth to continue in the intermediate term.

Additionally, some politically-driven factors could serve to further extend the economic expansion. Foremost among these, tax reform, if passed, is likely to help companies' profits and, in turn, support corporate investment activity, employment, and wage growth over time. Broad earnings improvement from tax reform could also serve as an additional catalyst for the stock market as a whole, though we do not see tax reform as necessary for the current U.S. or global equity bull market to continue. Initially, certain economically-cyclical sectors of the stock market like Industrials and Materials could see a bigger temporary boost, but, we believe any economic acceleration from tax changes should prove fleeting and investors will quickly refocus on sectors with more enduring growth drivers.

Inflation and Interest Rates: Our analysis suggests that U.S. inflation is likely to increase moderately as economic growth continues. We believe investor concerns over recent disinflationary pressures are overdone. Some of the main factors that have held down inflation this year are easing, such as the reintroduction of unlimited wireless data plans in Q1, which has trimmed as much as 0.2 percentage points off of year-over-year core inflation, and an unusual period of food price deflation that has helped limit headline inflation.

Meanwhile, fundamental factors should place upward pressure on intermediate and longer-term inflation. Labor costs are poised to rise, as the labor market has tightened substantially. Figure 2 shows that unfilled job openings have increased, yet wage growth has remained slow. Given the low current unemployment rate, employers will need to pay more to fill open positions and retain existing workers. Rising wages, in turn, should put upward pressure on inflation

Figure 2: Job Openings may Precede Wage Growth



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

Additionally, the decline in the U.S. dollar versus other major currencies over the past year could put upward pressure on import prices. While we do expect the dollar to appreciate going forward, inflationary pressures will likely linger for some time.

Rising inflation expectations, which get priced into interest rates, is one factor that should lead to higher rates in the environment ahead, especially on the long end of the yield curve. Additionally, the Federal Reserve has indicated it will keep raising short-term interest rates, particularly if inflation ticks up. It also plans to begin reducing its holdings of Treasury and agency securities, which could put additional upward pressure on longer-term rates.

> **U.S. Financials Sector Increase:**
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> *A pullback in longer-term interest rates and prospects for regulatory corporate tax reform presented an attractive opportunity to add to U.S. Financials exposure in Q3.*

After dipping early in Q3, interest rates began to rise in September. So did the U.S. Financials Sector, as investors anticipated banks should generate more income from their floating-rate and short-term loans. Despite the September rally in Financials, our outlook for the sector remains positive, and this view goes well beyond just our interest rate outlook. Financials stocks should also benefit materially from regulatory reform that lowers costs for major financial firms and increases their flexibility in deploying capital. Contrary to popular perception, much of this type of reform is not dependent on legislation, but will be implemented through executive action and existing regulatory authority.

Other economically-cyclical U.S. sectors also rallied in September, including Energy and Industrials. Given the limited fuel available for economic reacceleration, however, we do not anticipate their outperformance will be sustained in the environment ahead. In contrast to Financials, these sectors lack non-economic (e.g. regulatory) catalysts and secular tailwinds. The Energy Sector, in particular, continues to face poor oil price fundamentals and has an extreme valuation that is dependent, in our view, on expectations for an unrealistic rebound in oil prices.

> **U.S. Energy Avoidance:**
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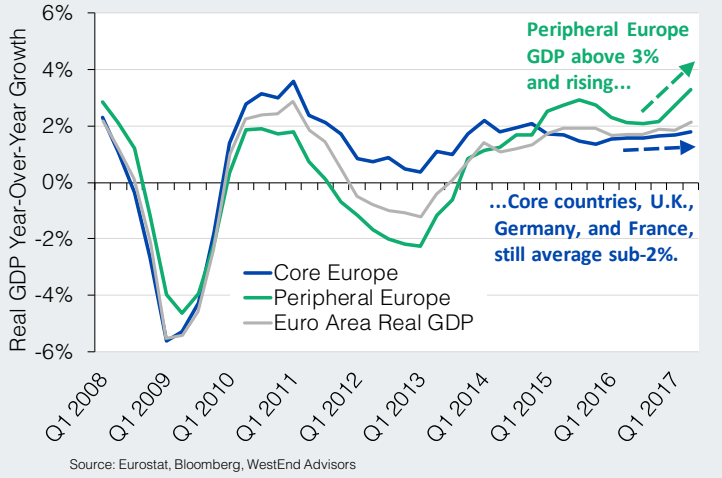
> *We continue to avoid U.S. Energy equities, which currently trade at over a 50% premium to the S&P 500's P/E multiple and lack either an economic or non-economic catalyst for performance.*

International Outlook: Our international outlook remains cautious relative to the opportunities we see in favored U.S. sectors. While we generally expect modest economic growth to continue globally, we see relative headwinds for economies outside the U.S. at this time, particularly for Europe given how conditions there have evolved this year.

We anticipated for some time that the economic growth gap between Europe and the U.S. would shrink, and that has occurred. However, recent improvement in European GDP growth has been largely due to reacceleration in Europe's smaller, peripheral economies. As illustrated in Figure 3, Europe's three largest economies – Germany, the U.K., and France, which account for more than half the region's GDP – continue their recent trend of sub-2% growth. We do not expect growth in Europe's peripheral economies will continue to accelerate, nor that the recent improvement will translate into meaningful earnings growth for stocks in the region, particularly given the appreciation of the Euro year-to-date.

Figure 3: European Growth not from the Core



Source: Eurostat, Bloomberg, WestEnd Advisors

We believe economic growth in the major countries that make up the bulk of Europe's equity markets is unlikely to improve materially. Serious structural and internal political challenges to European growth remain, as seen with Brexit and the recent Catalan independence push. Meanwhile, the honeymoon period is ending for French president Macron, and the German elections in September leave Merkel on uncertain footing. We see more potential for modest economic acceleration in the U.S. going forward, and allocations to select sectors in the U.S. should present the opportunity for outperformance in the environment we see ahead.

European exposure Reduced, U.S. increased: *Given Europe's challenges, we modestly reduced European equity exposure and increased our U.S. equity overweight – we believe select U.S. sectors offer greater potential for outperformance.*

For Asia and global emerging markets, we continue to see headwinds. Asia is suffering from a mix of challenges, such as China's need to balance slowing growth with an increasing debt burden. Underlying economic activity in Japan remains sluggish, with industrial production still below pre-2008 crisis levels. Export-driven economies in Asia and other regions also have to contend with weakened demand from the U.S. tied to recent weakness in the U.S. dollar. Yet, many emerging markets may face weaker investment flows and higher borrowing costs if the dollar strengthens as we expect.

Conclusion

Given our outlook for continued modest economic expansion, we continue to favor U.S. equity sectors with positive secular trends that reduce reliance on the economy for driving attractive earnings growth. For example, Health Care remains our largest U.S. sector overweight and is still valued at an unusual discount to the broad market. We anticipate investors will increasingly see the sector more as a source of stable earnings growth in the modest economic environment ahead. We also remain overweight the Information Technology Sector, which should benefit from secular growth trends in cloud computing, digital advertising, and e-commerce. However, following Technology's strong performance year-to-date, we chose to reduce our overweight in order to fund an increased Financials allocation.

Our underweight to international equities, including our recent reduction in European exposure, reflects confidence in the mix of U.S. sectors we currently favor relative to opportunities abroad.

For portfolios with a fixed-income component, our allocations to equities and fixed income are currently in line with portfolio benchmarks. This represents a balance between the risks of rising rates, progress made in the economic cycle and the expansion of equity valuations in recent years. Within fixed-income allocations, we continue to emphasize shorter durations and have modestly increased exposure to inflation-protected securities, given the risk of rising longer-term rates and inflation.

We believe our portfolios are well positioned for the environment ahead. As always, we continue to evaluate the macro environment and will adjust portfolios as our outlook evolves.

WestEnd Advisors Investment Team

October 16, 2017

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The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The total return of the MSCI ACWI (Net) Index is calculated using net dividends. Net total return reflects the reinvestment of dividends after the deduction of withholding taxes, using (for international indices) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. The Standard and Poor's 500 Stock Index includes approximately 500 stocks and is a common measure of the performance of the overall U.S. stock market. An index is unmanaged and is not available for direct investment.

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