Market Calm Ends, Economic Expansion Extends

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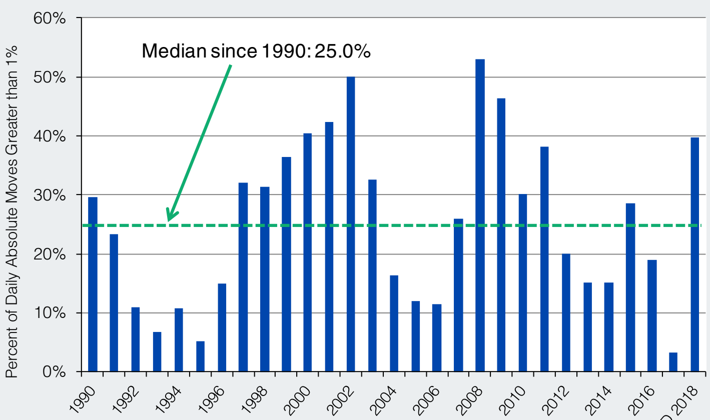
Q1 2018 Review

Equity markets saw a return of volatility in the first quarter of 2018 (Q1) following two years of unusual calm. In 2017, for example, the S&P 500 did not have a single day when the index was down 2%, and only had eight days when the index moved 1% or more in either direction, the fewest in over 50 years. That trend continued into January, with the MSCI ACWI global equity index posting the largest of 15 consecutive monthly gains. However, by early February, fears of inflation and rising interest rates in the U.S. had spooked investors. Equity markets around the world slid about 10% in a matter of days. Volatility continued through quarter-end, as the announcement of U.S. steel and aluminum tariffs sparked fears that a trade war could erode economic stability. Turnover in the Trump Administration also added to investor unease. Equity markets ended the quarter near February lows, with the MSCI ACWI returning -0.96%, its first quarterly loss since Q3 2015.

Figure 1: S&P 500 Volatility



Source: Bloomberg, WestEnd Advisors

U.S. economic releases were mixed in Q1, though they generally suggested continued moderate growth, in line with our outlook. Consumers remained a point of relative strength in Q1, with core retail sales rising 3.9% year-over-year—a healthy level and a modest improvement from the 3.7% average for 2017. The unemployment rate remained at 4.1% for a sixth straight month in March. Given the Q1 data, expectations for 2018 GDP growth are moderate. For example, the Atlanta Federal Reserve's "GDPNow" estimate for Q1 GDP ended the quarter at 2.4%, roughly in line with Wall Street estimates.

Eurozone economic data softened in Q1, after the monetary union posted its highest GDP in a decade in 2017 (though even that was only 2.5%). Eurozone GDP growth is expected to slow to 2.1% in 2018 and 1.7% in 2019. Economic growth in Asia is also expected to slow in 2018. China's GDP is expected to be 6.5% in 2018, down from a reported 6.9% in 2017. Japanese industrial production and retail sales both decelerated in Q1, after the country posted modest GDP growth of 1.6% in Q4, signaling weaker growth to start the year.

In the capital markets, U.S. stocks were led by the Information Technology and Consumer Discretionary Sectors. Laggards in the U.S. included a mix of economically cyclical equity sectors, like Materials and Energy, and traditionally defensive sectors, like Consumer Staples and Telecom Services. Interest rate-sensitive sectors, including Utilities and Real Estate, as well as longer-duration fixed-income securities, also lagged as interest rates rose in Q1. Internationally, emerging market equities led as Brazil, Russia, and China outperformed. Major developed international equity markets generally underperformed in Q1, particularly in local currency terms.

Outlook

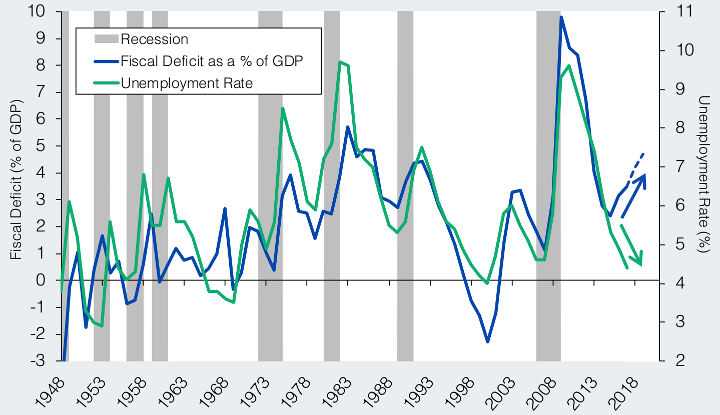
Despite recent market volatility, our fundamental economic and corporate earnings outlook has not shifted materially. We expect continued moderate economic growth globally, with rising inflation and interest rates in the U.S. and continued structural challenges abroad. Additionally, while the risks of an escalating trade war could present a headwind to U.S. and global growth, equity markets have already reacted sharply to what we see as a low probability of escalation. Volatility is normal in equity markets, and may help set the stage for markets to refocus on fundamentals, even as rising interest rates are likely to weigh on returns of fixed-income and other interest rate-sensitive investments.

Some Equity Market Volatility is Normal:

Despite recent market volatility, our fundamental economic and corporate earnings outlook has not shifted materially.

U.S. Economy: The U.S. economy is in its ninth year of expansion, and while economic growth has been slower than in other post-war expansions, substantial economic progress has been made over the extended duration of this cycle. Another unique aspect of this expansion is that the U.S. government appears to be engaged in fiscal stimulus by increasing the budget deficit late in the cycle. The U.S. budget deficit increased as a percentage of GDP in both fiscal 2016 and 2017, which is virtually unprecedented late in a peacetime expansion with a falling unemployment rate (see Figure 2). Further, the recent taxcuts and new appropriations legislation suggest deficit spending is likely to continue increasing in 2018 and beyond.

Figure 2: Fiscal Deficit and Unemployment Rate



Source: Office of Management and Budget, Bureau of Labor Statistics, Deutsche Bank, WestEnd Advisors

We do anticipate personal tax cuts will have a positive impact on consumer spending. This should help extend the economic cycle, in our view, but with the economy near full employment and pent-up demand largely exhausted, the tax cuts are unlikely to drive a material reacceleration in growth.

Inflation and Interest Rates: We expect interest rates will continue to rise at a modest pace. Inflation expectations, a key driver of longer-term interest rates, rose materially in the six months ended Q1 to just over 2%, based on the yield spread for TIPS. Meanwhile, the Federal Reserve raised the Fed Funds rate in March and affirmed the likelihood of at least two more rate hikes this year. Federal Open Market Committee member projections also suggested more increases in 2019 and 2020 than was previously anticipated, so it is reasonable to expect short-term rates will continue to rise.

Investor concern over rising rates was one of the catalysts for stock market volatility in recent months. Interestingly, the stock market pullback in early February was the first time since the financial crisis that stocks approached or entered a correction without the yield on 10-year Treasury bonds falling. This could be a symptom of the later phases of the economic cycle, with upward pressure on interest rates outweighing downward pressure from a flight to safety.

We continue to avoid the most interest rate-sensitive parts of the U.S. equity markets, such as the Utilities and Real Estate Sectors. We also continue to emphasize short-duration securities in portfolios with fixed-income allocations and, following the recent uptick in inflation expectations, shifted some fixed income exposure from inflation-protected securities to floating-rate securities.

U.S. Equity Valuations: The forward price-to-earnings (P/E) ratio of U.S. stocks has fallen materially in recent months, from about 18.5x in mid-December to about 16.4x at the end of Q1. Despite the sharp pullback in stock prices in Q1, reduced valuations from their mid-December peak are primarily a result of increased earnings growth expectations tied, in large part, to corporate tax reform. The importance of the increased earnings expectations has been masked somewhat by recent market volatility. Rising earnings expectations were initially met with strong equity price gains through January, and the valuation reset was apparent only after equity indices fell back to December levels later in Q1.

Even after the valuation reset, we still see sectors with both cyclical and secular earnings growth drivers as most attractive in the current environment, including Information Technology, Health Care, and Consumer Discretionary. We continue to avoid most economically-cyclical areas of the market (in addition to avoiding interest rate-sensitive sectors, as already mentioned). It is worth noting that later this year some parts of the Technology and Consumer Discretionary Sectors will be reclassified and combined with the entire Telecom Services Sector to form a new "Communications Services Sector." Given our investment focus on sectors in the U.S., we view this reclassification positively, as it should result in more economically cohesive sectors. The reclassification will largely represent a relabeling and reorganization of our existing holdings and does not change our views on underlying exposures. Please see the callout box below for additional details on the reclassification.

The New Communications Services Sector:

On September 28, 2018, Standard & Poor's and MSCI will reorganize their Global Industry Classification Standard (GICS) to create the "Communication Services Sector" by renaming and expanding the Telecommunications Services Sector. This new sector will combine:

1. *The current Telecommunication Services Sector (e.g. AT&T, Verizon, etc.*)*
2. *Media, advertising, and entertainment companies taken from the Consumer Discretionary Sector (e.g. Disney, Netflix, The New York Times Co., etc.*)*
3. *Certain Internet and entertainment software companies taken from the Information Technology Sector (e.g. Alphabet, Facebook, etc.*)*

This reclassification will have several notable impacts. From an economic perspective, companies in the revised sectors will have more in common with each other and, as a group, be more distinct from other sectors. We expect the new sectors may thus be more responsive to distinct economic drivers, and therefore fit well with our macroeconomically-driven sector allocation approach. This may also create opportunity for additional excess return generation through increased dispersion of sector performance. The reclassification also redistributes investment opportunities more evenly among sectors, as portions of the relatively large Information Technology and Consumer Discretionary Sectors will be combined with the much smaller Telecommunication Services Sector. There will likely be shifts in expected growth rates and valuations for the affected sectors, though given our current portfolio exposures, this should not materially impact our overall portfolio characteristics.

* Examples selected for recognizability. Lists of affected companies are available at www.spindices.com and www.msci.com.

On balance, we believe continued moderate economic growth should be good for stocks. The lack of strong economic momentum, however, leaves room for more volatility ahead as investor sentiment swings between upside and downside risks.

International Trade: Uncertainty around trade policy and the risks of a trade war have become a primary focus of markets in the wake of the Trump Administration's March 1st announcement of steel and aluminum tariffs. Tariffs are taxes that increase the cost of foreign goods. This can produce a limited set of winners (e.g. domestic producers of the goods taxed at the border) in the short run. Longer-term, however, tariffs produce a large set of potential losers. Consumers almost inevitably end up paying higher prices, either on the imported goods or because tariffs allow domestic producers to raise prices. Aggregate growth is also likely to suffer from tariffs, due to supply chain disruptions and restrained exports. As such, tariffs could offset some or all of the potential economic benefits of the recent tax cuts.

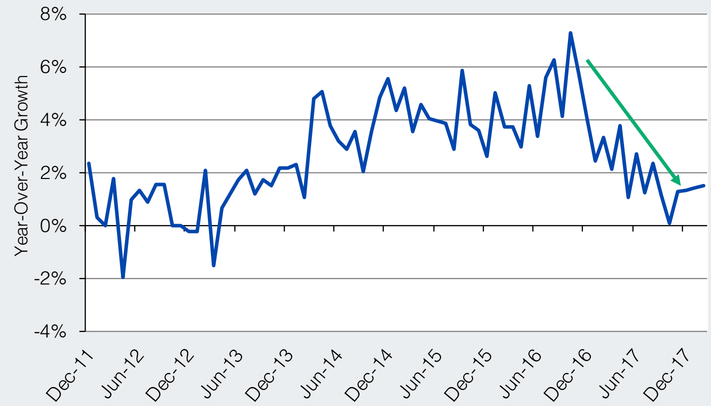
We do not believe, however, that a major increase in trade barriers is the most likely scenario. President Trump likely wants to be seen as fulfilling certain campaign promises, and it is not uncommon for presidents to impose some tariffs—Reagan placed tariffs and quotas on various Japanese goods in the 1980s, and George W. Bush placed tariffs on steel in 2002. Almost all of these measures were removed under the same administration that imposed them, and the Trump Administration has already reduced the scope of its steel and aluminum tariffs.

Regardless of the likelihood of a trade war, we believe our portfolios are well positioned in the face of ongoing trade tensions. We continue to avoid or underweight the most economically sensitive areas of the global equity markets, including certain cyclical sectors in the U.S. and emerging markets internationally. Within fixed income allocations, our emphasis on short-duration, floating-rate, and inflation-protected securities in anticipation of rising rates also provides protection from the potential inflationary impacts of a trade war.

International Economies: Outside the U.S., many economies continue to face cyclical and structural challenges to growth. Emerging markets, which typically have the highest growth rates during a global expansion, have seen deterioration of key growth drivers recently. For example, growth of exports, a key pillar of many emerging economies, has slowed. Additionally, risks to economic stability in China, the largest emerging market, have increased with rising debt loads. Over the past decade, the debt of China's private non-financial sector has increased six-fold in U.S. dollar terms and now represents 211% of the country's GDP, according to the most recent data from the Bank of Internationals Settlements. For comparison, the U.S. ratio is 152%, which is below its 10-year average.

In the developed world, the U.K. is likely to be a drag on European growth as a whole. In 2017, the U.K. imported nearly half a trillion dollars in goods and services from the E.U., and post-Brexit trade rules could weigh on U.K. demand for E.U. output. The U.K.'s internal consumer demand growth is also slowing. As noted in Figure 3, the growth trend of real retail sales in the U.K. has slowed materially over the past 18 months. We see ongoing risks for the U.K. and E.U. in the near-term, and remain underweight the region.

Figure 3: U.K. Real Retail Sales Growth



Source: UK Office for National Statistics, WestEnd Advisors

In Asia, Japan represents a drag on economic growth. Excluding inventory build, an unsustainable growth driver, Japan's economy decelerated over the past year. Given ongoing challenges for Japan's economy, we see few catalysts for improvement in the near-term. We continue to underweight Japan and, more broadly, the Asia/Pacific region.

Conclusion

Recent equity market volatility, while pronounced in contrast to the relative calm of the last few years, is fairly normal in our view and, in of itself, does not change our outlook. We expect moderate economic growth to continue globally, and modest increases in inflation and interest rates are likely to continue in the U.S.

As the economic cycle continues to mature, we see the best equity market opportunities in select U.S. sectors with a mix of secular and cyclical earnings growth drivers. We continue to avoid the most economically-sensitive and interest rate-sensitive U.S. sectors and, in global portfolios, remain underweight international equity markets. For portfolios with fixed-income allocations, we continue to emphasize short-duration securities, given the risk of rising interest rates.

As always, we continually analyze the macroeconomic and market environments, and we will adjust our outlook and portfolios as warranted. We appreciate your confidence in WestEnd Advisors, and invite you to contact us with any questions you may have on our outlook or portfolios.

WestEnd Advisors Investment Team

April 16, 2018

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The MSCI ACWI consists of 47 country indexes comprising 23 developed and 24 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 MSCI Europe Index represents a subset of the MSCI ACWI, comprising 15 developed market country indexes in Europe. 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.

Holdings, Sector Weightings, and Portfolio Characteristics were current as of the date specified in this presentation. The listing of particular securities should not be considered a recommendation to purchase or sell these securities. While these securities were among WestEnd Advisors' holdings at the time this material was assembled, holdings will change over time. There can be no assurance that the securities remain in the portfolio or that other securities have not been purchased. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities presently in the portfolio. Individual clients' portfolios may vary. Upon request, WestEnd Advisors will provide a list of all recommendations for the prior year.