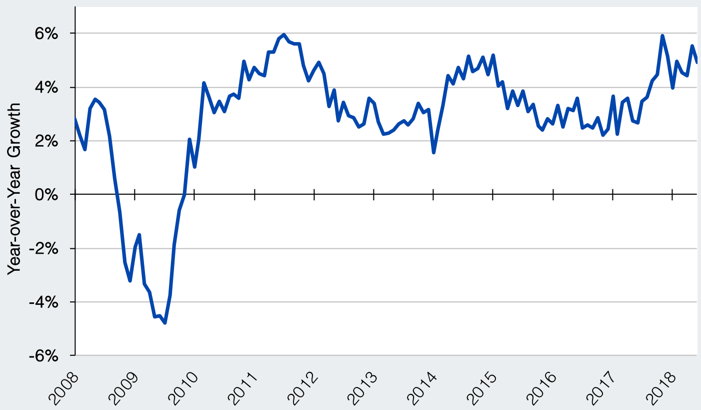
Mostly Sunny at Home, Partly Cloudy Abroad

Prospects for a temporary reacceleration of economic growth in the U.S., and for continued trade tensions globally, do not change our fundamental view that the U.S. is on a favorable path of moderate economic growth while challenges remain abroad.

Q2 2018 Review

Moderate economic growth continued in the U.S. during the second quarter of 2018 (Q2). Payroll employment gains remained solid, averaging over 210,000 per month in Q2, while real GDP growth decelerated to a 2.0% annualized rate in the first quarter (Q1), in line with the average pace of economic growth over the last few years. The consumer remained a key source of economic strength in Q2, with core retail sales posting 4.9% year-over-year growth in June (see Figure 1). Consumer spending growth has been fueled by elevated measures of consumer confidence driven, in part, by a 45 year low in layoffs.

Figure 1: U.S. Core Retail Sales



Source: U.S. Census Bureau, Bloomberg, WestEnd Advisors

U.S. equity markets posted solid gains in Q2, with the S&P 500 Index returning 3.43%. Equity market volatility also eased from Q1. Investors in the U.S. largely seemed to take escalating trade disputes in stride, likely assuming trade rhetoric and policy actions will de-escalate. U.S. sector performance was mixed in Q2. Energy was the best-performing sector last quarter, following significant underperformance in Q1, as the price of oil rose in April amid short-term supply concerns. The Information Technology and Consumer Discretionary Sectors also outperformed, and the Health Care Sector received a boost in May as the Trump administration released its *Blueprint to Lower Drug Prices*, which reduced uncertainty around drug pricing for pharmaceutical and biotech firms. Interest rate-sensitive sectors like Utilities and Consumer Staples underperformed.

International equity markets underperformed in U.S. dollar terms in Q2, with the MSCI ACWI ex-U.S. returning -2.62% as the dollar appreciated materially against most other currencies. While most developed markets rose in their local currencies, the dollar's strength reduced those returns for U.S.-based investors. Emerging markets underperformed both the U.S. and developed international markets, likely exhibiting heightened sensitivity to signs of slowing economic growth abroad, the rising dollar, and trade tensions.

The Federal Reserve (Fed) once again raised its target Fed Funds rate in June. The move up in longer-term Treasury rates was less pronounced in Q2, following significant increases in Q4 and Q1, as inflation appeared to stabilize just above two percent.

Outlook

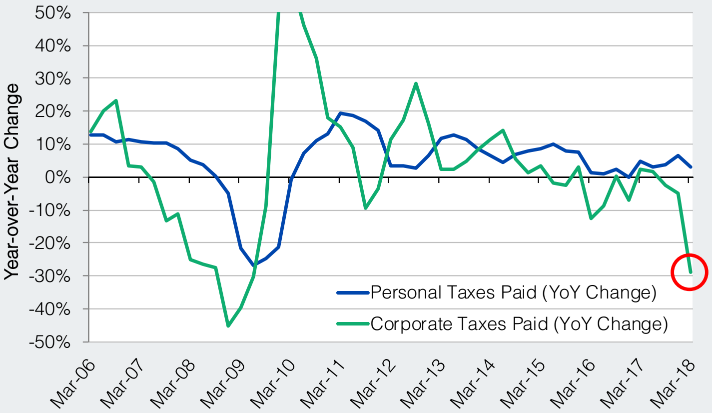
We continue to have a constructive view of global equity markets, and of select U.S. sectors, in particular. The Health Care and Information Technology Sectors, for example, should benefit from a mix of cyclical and secular tailwinds. While macroeconomic and political factors continue to evolve, we believe that the U.S. will continue to deliver moderate economic growth. Challenges are more pronounced abroad, due in part to ongoing structural headwinds and persistent slow growth in overseas developed markets. Higher interest rates in the U.S. and the potential for continued U.S. dollar strength also present elevated risks for emerging markets.

U.S. Economy: Expectations for economic reacceleration in the U.S. have increased in recent months. Some recent data does suggest there was a pick-up in Q2 GDP growth, but we believe any material reacceleration of growth is unlikely to be sustained. Factors that may boost the GDP reading for Q2 are likely to prove transitory, including a possible benefit from an inventory build, a skewing of import growth data from one-time payments for Olympic broadcasting rights in Q1, and a rush to export goods like soy beans in Q2 ahead of the implementation of overseas tariffs. We expect, however, that the trend of moderate economic growth which has typified this near-decade-long U.S. expansion will persist in the intermediate term.

The U.S. consumer should remain a key area of strength for the economy. Steady gains in disposable personal income (personal income less taxes paid) for individuals have supported consumer spending and the overall economy. In fact, disposable income growth stands at the highest level since early 2015. Lower individual tax rates have supported this after-tax income growth, but the elimination of various tax deductions materially offset the benefit of lower rates. Personal taxes paid as of May were down 2% compared to December 2017, but the measure was still up nearly 4% year-over-year. The limited net benefit of personal tax reform is another factor that reduces the probability of a material reacceleration of economic growth.

In contrast, businesses have been the bigger beneficiaries of tax reform. Corporate taxes paid, as measured by the Bureau of Economic Analysis, were down 29% in Q1 2018 compared to Q4 2017 (see Figure 2). This has provided a boost to 2018 earnings expectations and, in turn, brought down price-to-earnings multiples for U.S. stocks. Companies are also returning tax savings to shareholders through share buybacks and dividend increases, which should provide further support for stock prices.

Figure 2: Personal and Corporate Taxes Paid



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

While we have a positive view toward the U.S. economy and markets, we always assess potential risks to our outlook. Trade policy is a key risk in the current political environment. In our view, tariffs are effectively a tax paid by U.S. corporations and consumers in the form of higher costs for goods and services. Thus, the tariffs already enacted or announced by the U.S. could offset some of the positive growth effects of recent tax reform. Retaliatory tariffs from other nations could weigh on U.S. exports, adding to the case against sustained stronger growth here and abroad. Still, the risk of a full-blown and prolonged trade war remains small in our view. We believe that the administration (despite its rhetoric) will not want to risk the economic and political consequences of a broad trade war.

U.S. Equity Positioning: Given our U.S. outlook, we continue to avoid the most economically-sensitive U.S. sectors, such as Energy, Materials, and Industrials. In contrast, we currently favor U.S. equity sectors with a mix of positive cyclical and secular earnings growth drivers. For example, Information Technology should benefit from capital spending in a moderate economic growth environment, as well as from ongoing migrations to cloud computing, digital advertising, and electronic payments. Health Care and consumer-related sectors are additional examples of sectors that we see as attractive.

We also believe maintaining exposure to less economically-sensitive U.S. sectors is warranted, given the progress made thus far in the economic cycle, and we reallocated *within* our strategies' less economically-sensitive U.S. equity exposures during Q2. Specifically, a shift in market conditions presented an opportunity, in our view, to move back to a material overweight of U.S. Consumer Staples. From early 2017 through late Q2, valuations for the Consumer Staples Sector declined materially as sentiment turned overly negative toward the sector. At the same time, U.S. interest rates rose substantially, reducing a key risk to Consumer Staples stocks. As investors refocus on fundamentals in the current moderate economic growth environment, we believe stable earnings growth in the Consumer Staples Sector should support positive relative returns.

To fund the increase in Consumer Staples, we reduced exposure to the U.S. Health Care Sector, though we still maintain a very positive view of Health Care, which remains our largest U.S. sector overweight. The U.S. Health Care Sector provided strong absolute returns over the past year-and-a-half, roughly in line with the broad market. It had also materially outperformed in the second half of Q2 after the announcement of the Trump administration's *Blueprint to Lower Drug Prices* reduced some investor uncertainty toward the sector. Overall, our allocation adjustments represented an opportunity to take advantage of recent market shifts without changing our aggregate target exposure to less economically-sensitive U.S. sectors.

New Sector Coming Online: Communication Services

As we detailed in our Q1 2018 Economic and Market Commentary, the widely-used Global Industry Classification Standard is being reorganized to create a new "Communication Services Sector" at the end of Q3 2018. The new sector will combine the current Telecommunication Services Sector with various media, internet and entertainment companies taken from the Information Technology and Consumer Discretionary Sectors.

Fundamentally, we view this reclassification as a positive for our macroeconomically-driven sector allocation approach. The newly transformed sectors:

1. *Will be more economically aligned and, thus, more responsive to distinct economic drivers;*
2. *May increase performance dispersion across sectors, which creates opportunity for generating excess return from active sector allocation; and,*
3. *Will result in more evenly distributed sector weights, as portions of two larger sectors will be combined with one of the smallest sectors, allowing more room to overweight the larger sectors and underweight the smaller sector.*

With respect to portfolio implementation, we do not expect the reclassification will cause any material disruptions for our strategies. For our ETF-based portfolios, however, the shift will likely necessitate some adjustments to holdings in order maintain the market exposures we believe are appropriate at the end of Q3. Since the reclassification was announced, we have been communicating with major ETF providers to ensure we understand how they are implementing the reclassification across their ETFs, so we, in turn, can make informed portfolio adjustments as needed. As always, we seek to maintain flexibility in our ETF selection to ensure we can best align our portfolios with our outlook.

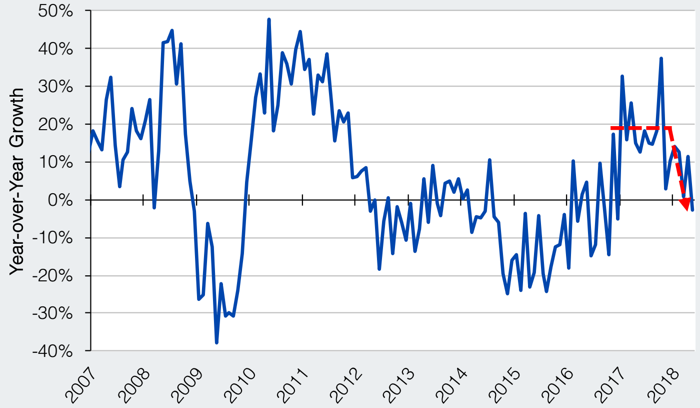
International Outlook: We have seen some economic deceleration abroad recently, which is in line with our international outlook. For example, while Eurozone real GDP growth had briefly converged with the U.S. in recent years, the boost to Europe's growth came largely from a rebound by its peripheral countries. We now are seeing European economic growth ease again, and a range of economic data has begun to disappoint relative to elevated market expectations. Structural challenges, like restrictive labor market regulation throughout Europe and political volatility in the periphery, present headwinds to sustained growth in the region.

We have been skeptical about how quickly the European Central Bank (ECB) would move off its highly accommodative monetary policy. Now, in fact, the ECB is undershooting broader investor expectations for normalization. In June, the ECB indicated it would not begin raising its overnight lending rate target until at least the summer of 2019. As the ECB keeps rates low, while the Fed continues to gradually tighten U.S. monetary policy, the differential between short-term interest rates in the U.S. and Europe will likely expand. This could drive capital flows from Europe to the U.S. and add to upward pressure on the U.S. dollar. That, in turn, could make European returns even less attractive for U.S. investors. Given these and other headwinds, such as the impact of Brexit and political uncertainty in Germany and Italy, we continue to underweight Europe in global portfolios.

Asia has its own structural headwinds, not least of which is continued consumer malaise in Japan. While Japanese equities have had occasional periods of outperformance in recent years, we have yet to see convincing signs of material sustained improvement in Japan's economic fundamentals. Further, its ties to emerging Asian economies—notably China and South Korea, which face their own challenges—could make a meaningful turnaround even more challenging for Japan in the near-term.

Emerging markets remain under threat from U.S. dollar strength. Many emerging markets are dependent on foreign investment to fuel economic growth. A rising dollar also weighs on returns for foreign investors, making capital flight a risk. Additionally, key fundamentals in some emerging markets have deteriorated recently. For example, the Chinese economy is increasingly reliant on internal consumption, but year-over-year growth in Chinese retail sales slowed to 8.5% as of May 2018, the slowest pace of growth since 2003. Separately, in Brazil, year-over-year export growth has slowed to 2.1% as of June from average growth of 18% in 2017 (see Figure 3).

Figure 3: Brazil Export Growth



Source: Ministry of Industry, Foreign Trade and Services, Bloomberg, WestEnd Advisors

Emerging market economies tend to be more reliant on exports than developed economies. This can make them particularly sensitive to even a modest deceleration in international economic growth. It also means that trade policy uncertainty in the U.S. (a key end-market for goods) can weigh heavily on emerging economies and markets.

U.S. Interest Rates: The trajectory of U.S. monetary policy is little changed over the past several quarters, and, looking forward, we still see the Fed gradually increasing the Fed Funds rate. This should continue to push up short-term interest rates in the U.S. Long-term interest rates have also moved up substantially from mid-2016 lows (though less than short-term rates) as inflation expectations increased and core inflation approached the Fed's 2% long-run target. Normalization of real (after inflation) long-term interest rates, however, which remain low by historical standards, could sustain upward pressure on nominal longer-term rates.

In this environment, we are emphasizing short-duration securities in portfolios with fixed-income allocations. This protects against capital loss from longer-duration fixed-income securities as rates rise. Further, as the yield curve has flattened, the opportunity cost of this interest rate risk protection has declined because the amount of income forgone by holding short-term rather than long-term fixed income has decreased significantly.

Conclusion

Our intermediate-term economic outlook remains positive. In particular, many U.S. fundamentals appear to be in good shape. We believe our strategies are well-positioned to take advantage of anticipated outperformance of select sectors in the U.S., such as Heath Care, Information Technology and Consumer Staples. At the same time, we are always watching global economic and market risks. Many of the current risks are typical of a cycle that has progressed into its later stages, with interest rates rising and limited fuel for economic reacceleration. Other risks, such as the potential for a prolonged trade war, are unlikely to be realized in our view, but we remain vigilant in our analysis of such factors. As always, we will adjust portfolios as appropriate based on our evolving outlook.

Thank you for your interest and confidence in WestEnd Advisors. We invite you to contact us with any questions you may have on our outlook or portfolios.

WestEnd Advisors Investment Team

July 16, 2018

This report should not be relied upon as investment advice or recommendations, and is not intended to predict the performance of any investment. These opinions may change at anytime without prior notice. All investments carry a certain degree of risk including the possible loss of principal, and an investment should be made with an understanding of the risks involved with owning a particular security or asset class. Portfolio characteristics and/or allocations are generally averages and are for illustrative purposes only and do not reflect the investments of an actual portfolio unless otherwise noted. Portfolios that are concentrated in a specific sector or industry may be subject to a higher degree of market risk than a portfolio whose investments are more diversified. While every effort has been made to verify the information contained herein, we make no representation as to its accuracy.

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.