Q3 2018

WestEnd Advisors

Macroeconomic Highlights

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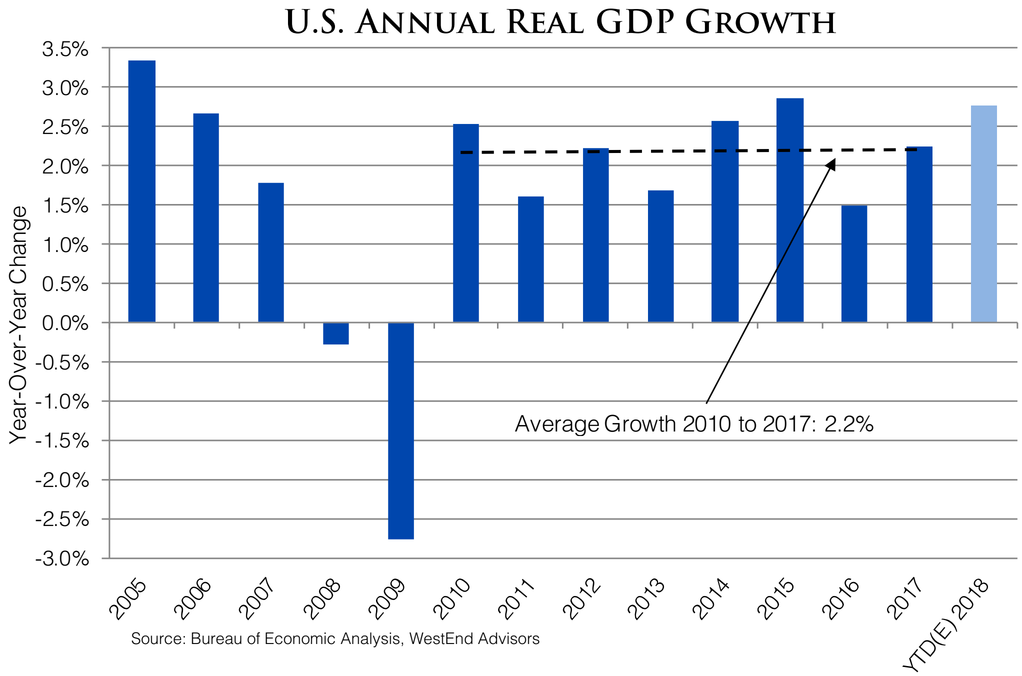
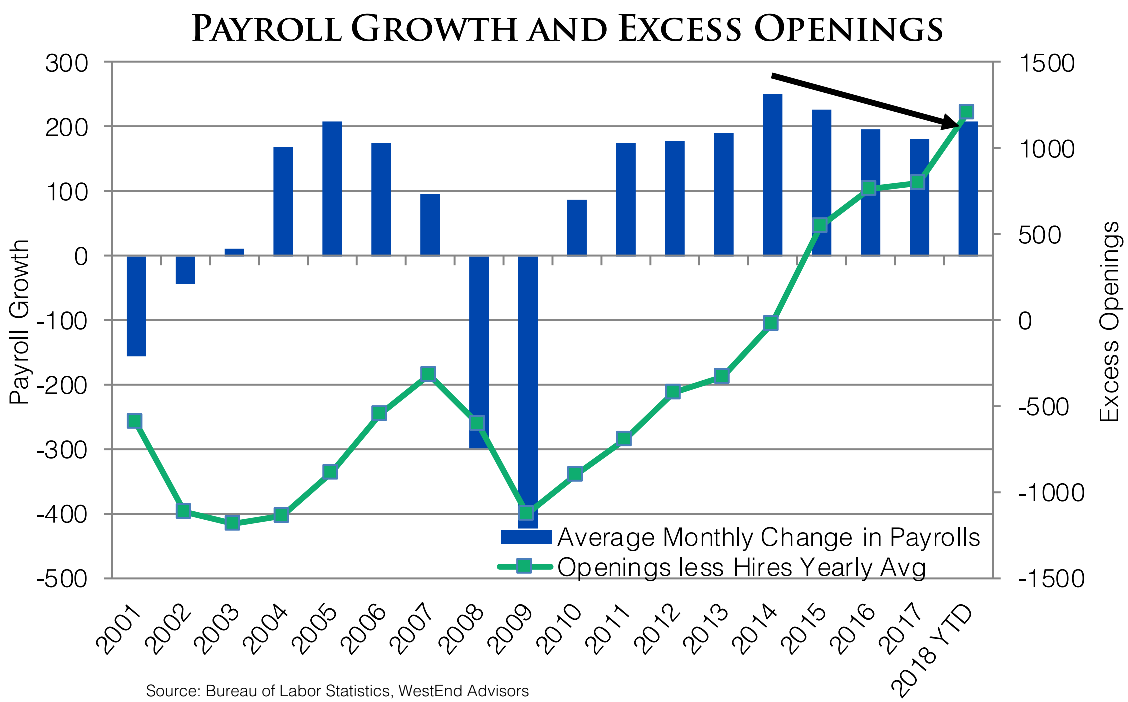
U.S. Economic Backdrop

Steady Growth Along with Progress in the Cycle





Annual real GDP growth has averaged just over 2% during the current economic expansion. Growth in the first half of 2018 is on pace to be at the upper end of the recent range of annual gains, but we do not see a sustained reacceleration.

The U.S. economy has made significant progress since the cyclical trough in 2009. This progress, which includes a rebound in auto sales, growth in construction spending and a tightening of the labor market (see the bottom chart for slowing payroll gains and soaring job openings) indicates there is limited economic fuel to drive sustained dynamic growth going forward.

Portfolio Impact

Technology & Health Care Sectors:

In a moderate growth environment, emphasize U.S. sectors that benefit from sustained cyclical and secular growth drivers.

Energy & Materials Sectors:

Avoid sectors that typically benefit from dynamic economic growth.

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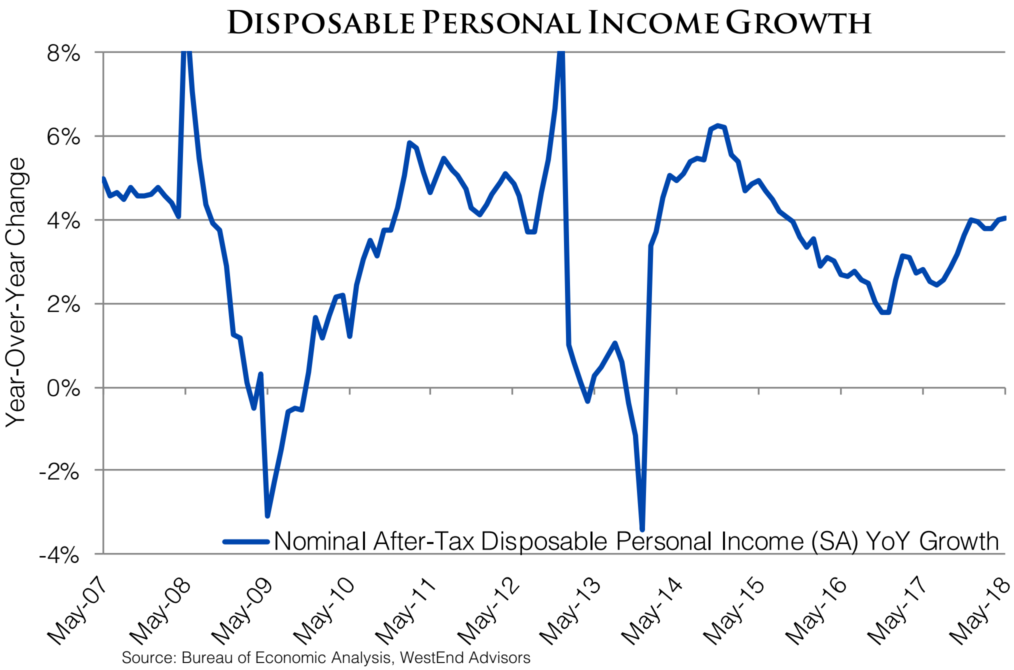
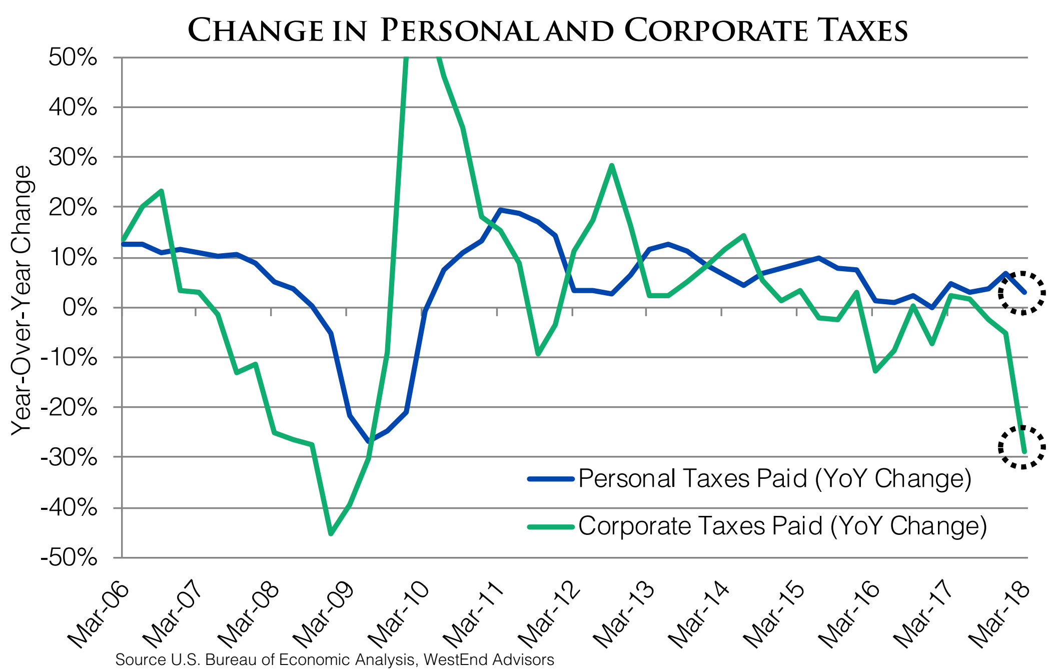
Consumer Income Growth Remains Healthy





Steady gains in disposable personal income (personal income less taxes paid) for individuals has supported consumer spending and the overall economy.

In fact, disposable income growth stands at its highest level since early 2015. Lower individual tax rates have supported this after-tax income growth, but the elimination of various tax deductions has been a material offset to lower tax rates. Personal taxes paid as of May were down 2% compared to December 2017, but the measure was still up nearly 4% compared to May 2017 due to income growth and the loss of tax deductions.

In contrast, businesses have been 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. The bottom chart highlights the divergence between the change in corporate and personal taxes paid.

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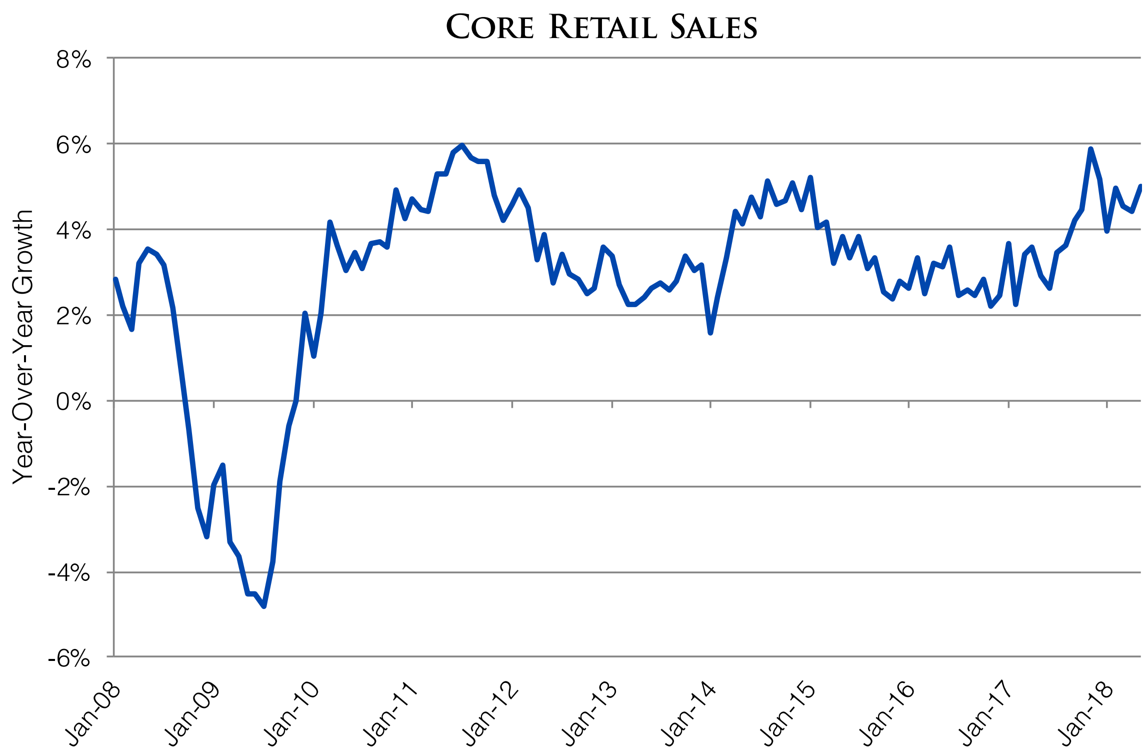
U.S. Consumer Spending Shows Strength



Source U.S. Census Bureau, WestEnd Advisors

Core retail sales (retail sales less more volatile spending categories including cars, building materials, restaurants and gasoline) continue to grow at a healthy pace, driven by record-low layoffs and strong income growth.

Wage and salary growth, for example, was up 4.9% year-over-year as of May 2018. Those gains were a key driver of the 5.0% annual growth in core retail sales for the 12 months ended May.

Portfolio Impact

We believe continued exposure to the consumer – a key driver of economic growth – via the Consumer Discretionary and Consumer Staples sectors is warranted, particularly as income growth and an elevated sense of job security among workers supports spending growth.

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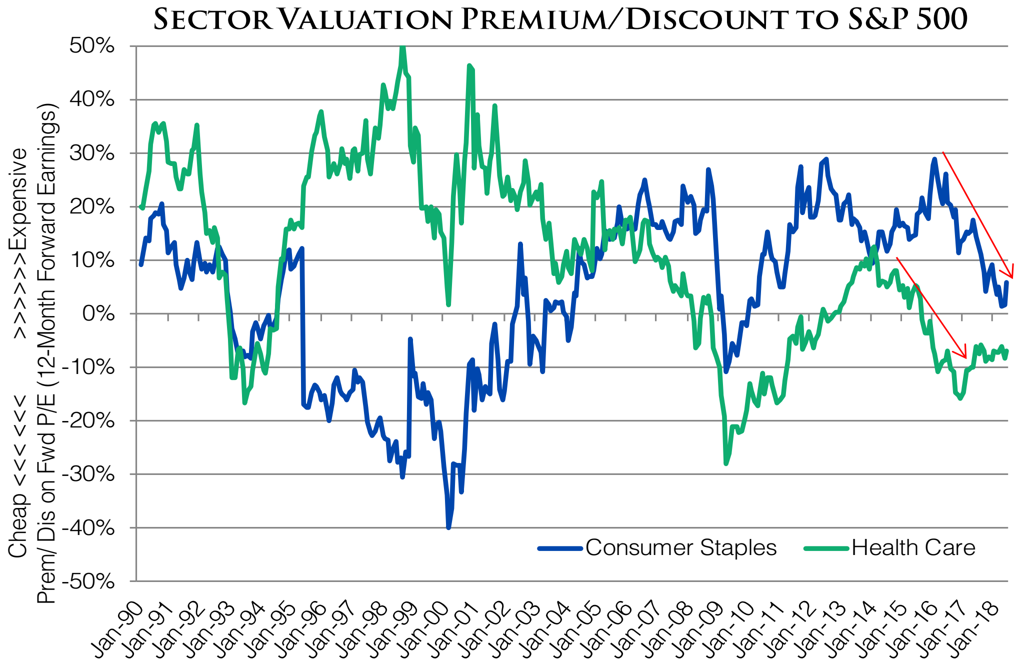
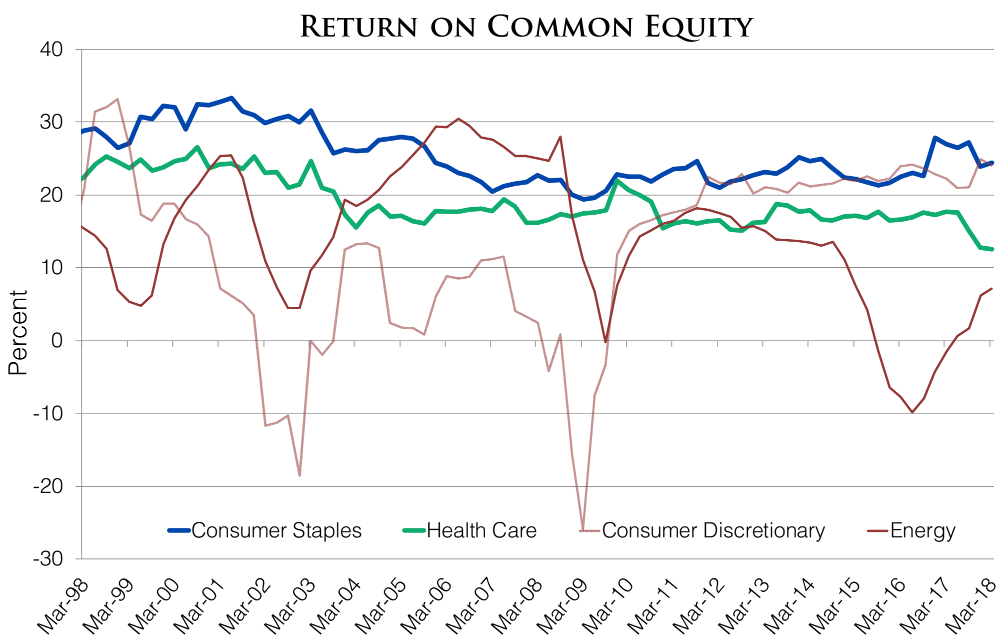
Consumer Staples: Turning the Corner



Source: Bloomberg, WestEnd Advisors



Source Bloomberg, WestEnd Advisors

The Consumer Staples Sector has underperformed this year as questions about secular challenges have weighed on valuations for many stocks in the sector.

We see the financial stability of Consumer Staples and Health Care as desirable, particularly as the economic cycle matures.

Consumer Staples and Health Care companies have generated above-market returns on equity (ROE) over time. More importantly, Consumer Staples' and Health Care's ROEs are very consistent, whereas economically sensitive sectors such as Consumer Discretionary and Energy have much more cyclical ROEs (see bottom chart).

Portfolio Impact

Consumer Staples & Heath Care Sectors:

Exposure to less economically sensitive sectors is warranted given the progress made thus far in the economic cycle.

A shift in market conditions presented an opportunity, in our view, to move back to a material overweight of Consumer Staples.

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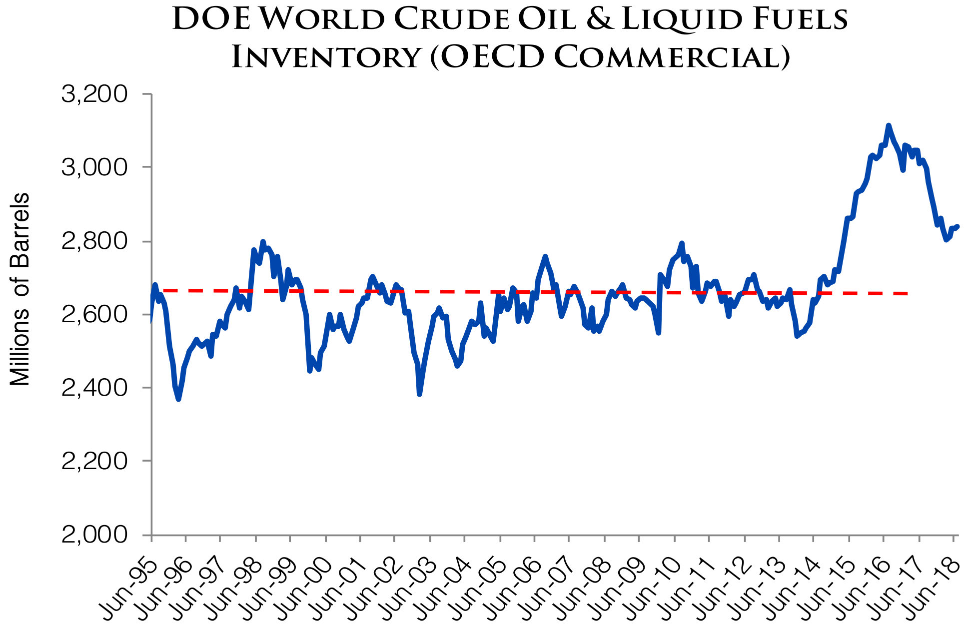
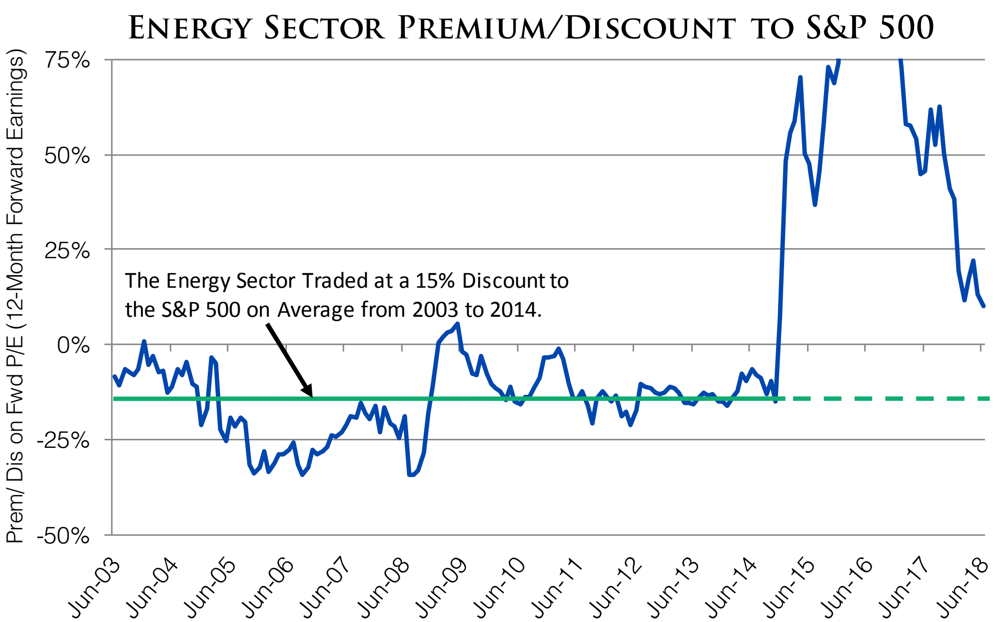
OIL DYNAMICS HAVE SHIFTED, BUT VALUATIONS STILL APPLY



Source: Bloomberg, WestEnd Advisors



Source Bloomberg, WestEnd Advisors

Global economic growth has been unexciting, which has kept demand for crude oil subdued. Even so, oil prices have increased recently on shifts in supply and inventories. Inventories came down starting in the second half of 2017. We expect that higher prices will bring on additional oil supply, particularly from non-OPEC countries. This has started to play out and is contributing to inventory stabilization.

Investors looking at Energy Sector stocks not only need evaluate the outlook for commodity prices and company earnings, but they also need to consider what they are paying for those earnings (i.e. price-to-earnings multiples). If you give Energy Sector companies full credit for analysts' consensus estimate of a 68% gain in Energy Sector earnings over the next year, the sector still trades at a 10% *premium* to the S&P vs. a 15% *discount* historically.

PORTFOLIO IMPACT

A low likelihood of dynamic economic growth together with elevated earnings expectations and premium valuations leads us to believe the risks outweigh the opportunities in the Energy Sector.

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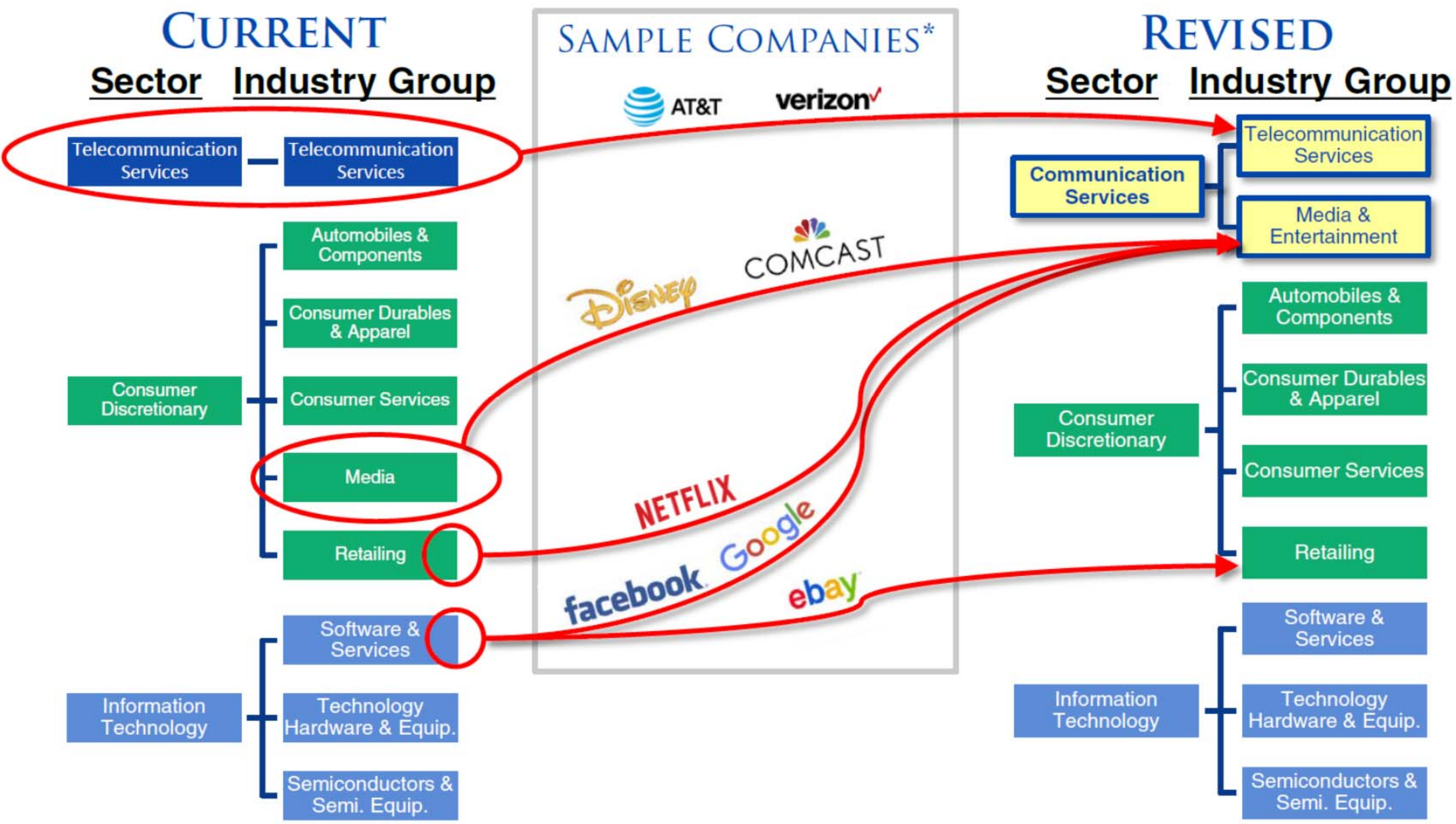
Communication Services Sector Comes Online



The widely-used Global Industry Classification Standard (GICS) 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 from the Information Technology and Consumer Discretionary Sectors.

After the changes, the S&P 500 sectors will have more evenly distributed sector weights, as portions of two currently large sectors (Tech & C.D.) will combine with one of the smallest sectors (Telecom), allowing more room to overweight larger sectors and underweight smaller sectors.

Portfolio impact:

We see the sector shifts as beneficial for sector-focused investment approaches as the changes better align investment opportunities with economic exposures.

* Sample companies were selected based on a combination of size and recognizability and are for illustrative purposes only.

Sources: MSCI, Standard & Poor's, WestEnd Advisors. Information has been gathered from sources believed to be reliable, however data is not guaranteed.

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Inflation and Interest Rates

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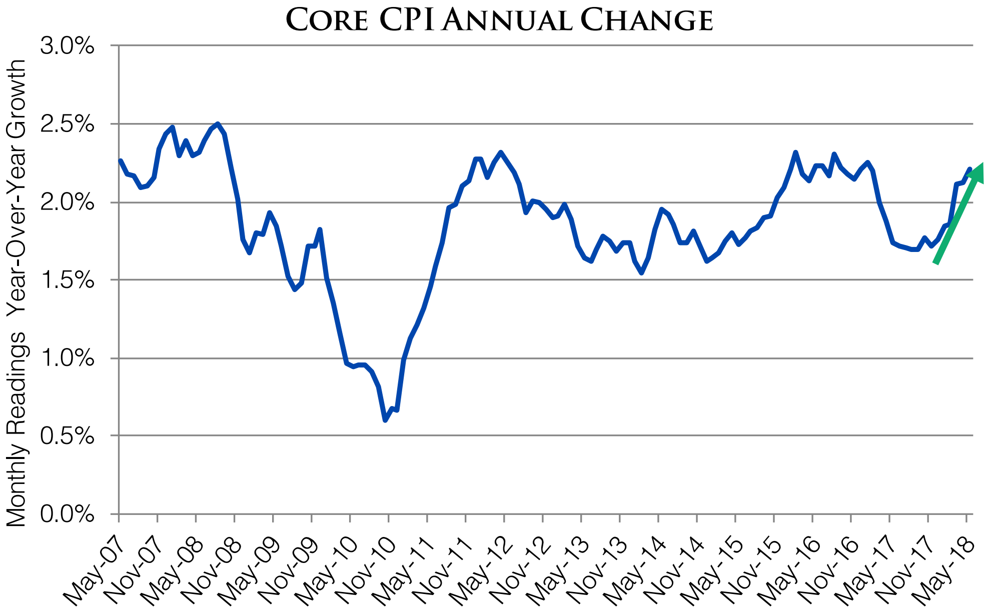
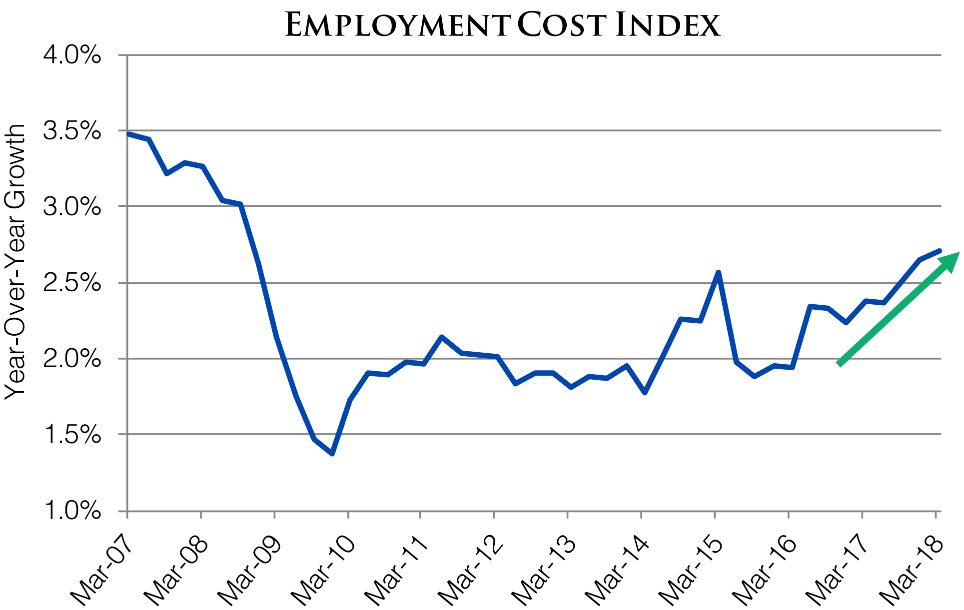
Inflation Plods Up as Signs of Wage Pressure Build



Source: Bureau of Labor Statistics, WestEnd Advisors



Source: Bureau of Labor Statistics, WestEnd Advisors

The Core Consumer Price Index (CPI less food and energy items) has moved higher in 2018 and reached 2.2% as of June. This the highest annual increase since January of 2017.

Even as the unemployment rate has declined significantly and the labor market has tightened, hourly compensation gains for workers have remained subdued. That said, there are indications of growing wage pressures.

The Employment Cost Index, for example, has moved higher in recent quarters, hitting the highest year-over-year growth in nearly 10 years as of Q1 2018. Inflation pressures should continue to push long-term interest rates higher, while Fed hikes will put upward pressure on short-term rates.

Portfolio Impact

Fixed Income: Emphasize short-duration securities. Exposure to investment-grade floating rate securities and TIPS are warranted.

Equities: Financials Sector should benefit from higher rates. Continue avoiding sectors most negatively impacted by rising rates, like Utilities and Real Estate.

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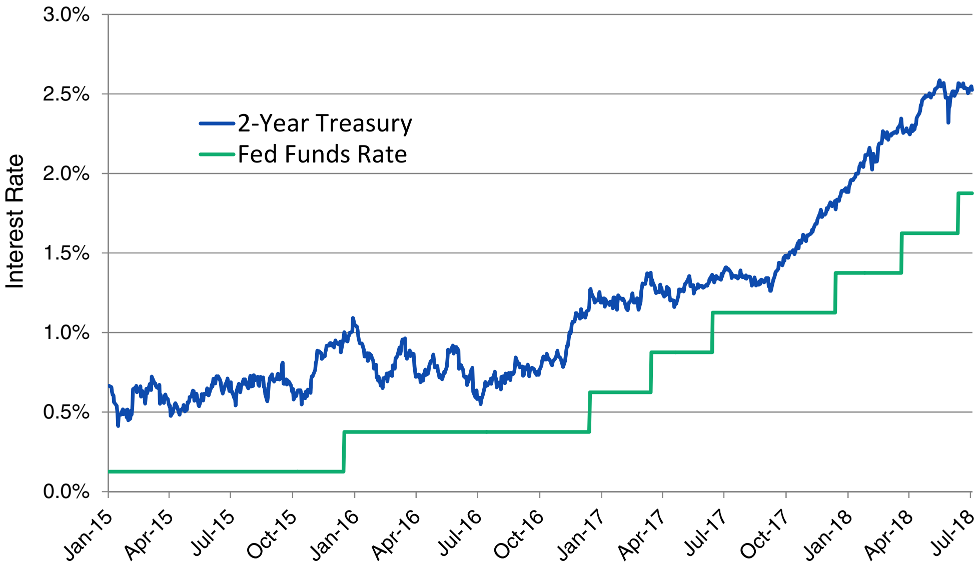
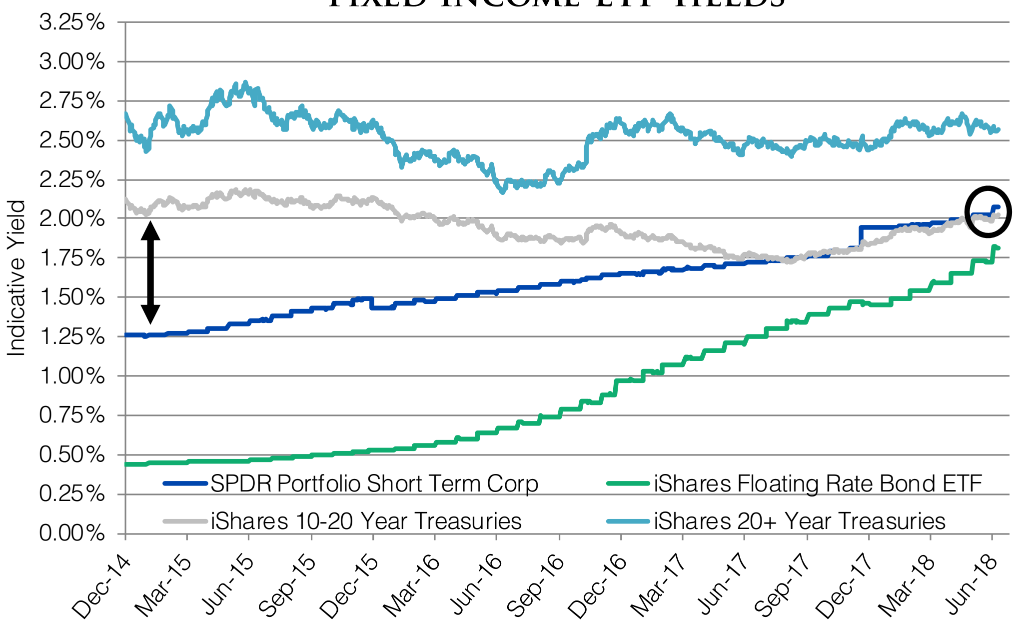
Fed's Policy Moves Impact Short-Term Bond Yields

Fed Funds Rate and 2-Year Treasury Yield



Source: Bureau of Labor Statistics, WestEnd Advisors

Fixed Income ETF Yields



Source: Bloomberg, WestEnd Advisors

Improved economic conditions and higher inflation readings led the Fed to increase the Fed Funds rate six times since December 2016 and, in turn, short-term interest rates have moved higher.

Higher short-term interest rates mean that the difference in income generation between long-term and short-term bonds has declined. For example, in early 2015, the yield on the investment grade Short-Term Corporate Bond ETF was 85 basis points *lower* than the yield on the 10-to-20 Year Treasury ETF. By the end of Q2 2018, however, the short-term corporate bond ETF's yield was 5 basis points *higher* than the long-term Treasury ETF's yield.

Looking ahead, longer maturity fixed income, in general, would be more negatively impacted by a continued move up in interest rates. Today, the 10-to-20 Year Treasury ETF has a duration of 10.6 years, while the Short-Term Corporate Bond ETF has a duration of just 1.9 years.

Portfolio Impact

Short duration bonds are more attractive today as the level of income sacrificed to insulate the portfolio from higher long-term interest rates has fallen as short-term interest rates have moved up.

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International Economic Backdrop

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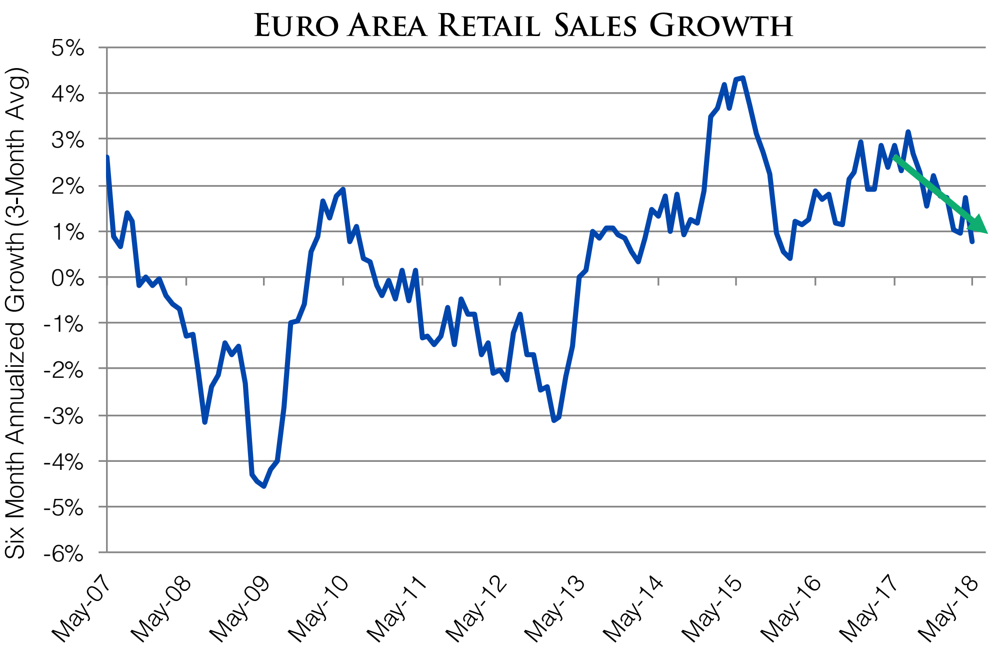
European Economic Picture Weakens in 2018



Source: Bloomberg, WestEnd Advisors

Sector Weights (%)		
	S&P 500	MSCI Europe
Information Technology	25.96	6.31
Health Care	14.07	11.88
Financials	13.84	18.49
Consumer Discretionary	12.92	11.11
Industrials	9.51	14.05
Consumer Staples	6.96	12.12
Energy	6.34	7.74
Utilities	2.95	3.46
Real Estate	2.86	2.58
Materials	2.60	8.36
Telecommunication Services	1.99	3.10

As of 6/30/2018

Source: Bloomberg, WestEnd Advisors

Data out of Europe thus far in 2018 has pointed to softer economic activity. For example, European retail sales and export growth have decelerated in recent quarters. Still some investors point to the valuation discount for European stocks compared to U.S. stocks. This 16% P/E discount on European stocks is very consistent with history, and one explanation for this discount is the sector makeup of each stock market.

The largest sector in Europe is Financials (≈19%) while the largest in the U.S. is Information Technology (≈26%). Given these weightings, it makes sense that Europe consistently trades at a discount to the U.S. Those who expect European equities' valuations to rise to U.S. equities' valuations are implicitly betting on significant expansion of European Financials' valuations, a view that we question.

Portfolio Impact

An underweight of European equities is warranted as lower valuations do not fully reflect the structural and cyclical economic headwinds faced by Europe.

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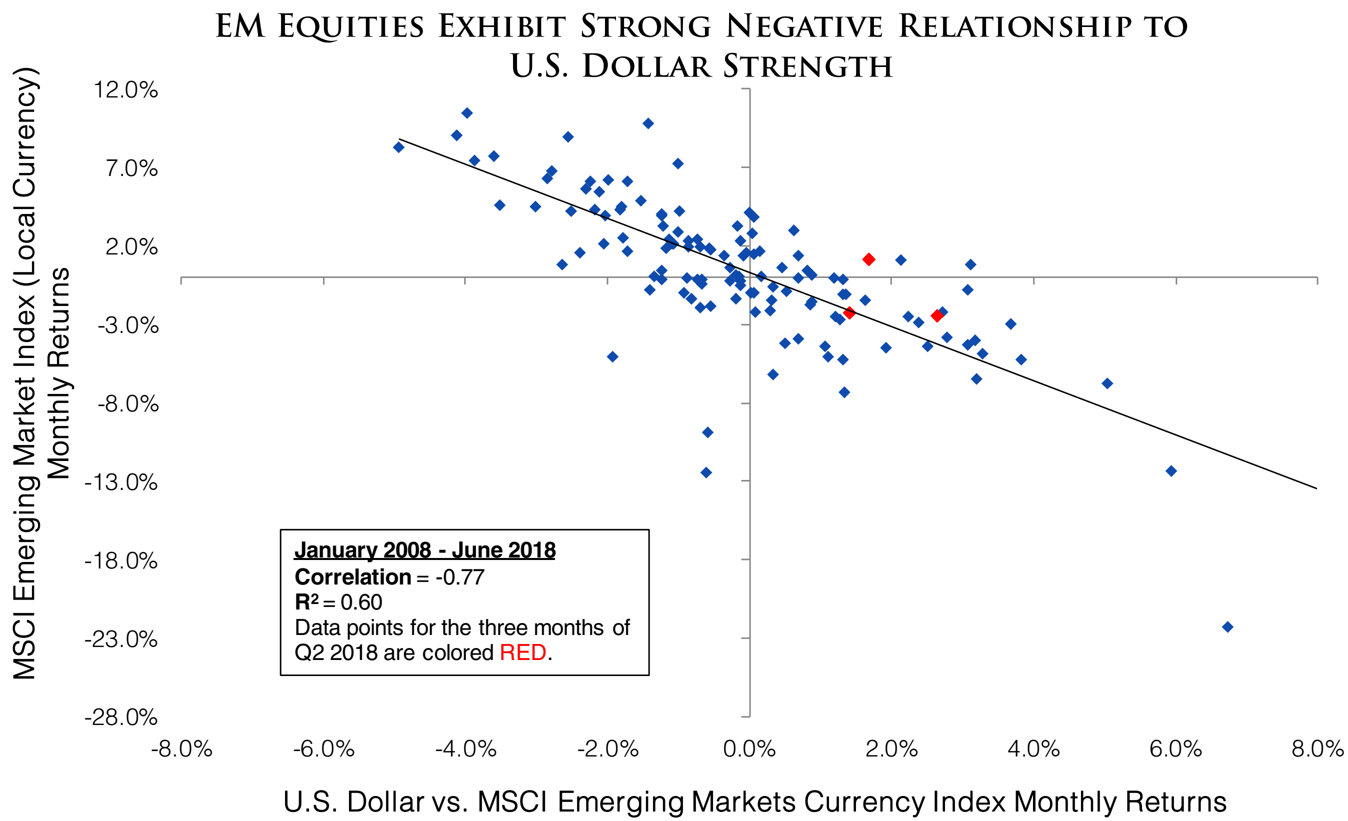
Emerging Market Stocks Impacted by the U.S. Dollar



Source: Bloomberg, WestEnd Advisors

Emerging markets (EM) stocks were hurt by the 6% appreciation in the U.S. dollar index compared to emerging market currencies in Q2.

The chart above illustrates that there is a strong negative correlation between emerging markets equity performance and moves in the U.S. dollar – i.e. EM stocks normally benefit from a weak dollar and suffer when the dollar appreciates compared to other currencies. While we do not anticipate a sharp move higher in the U.S. dollar, we do think that steady economic growth coupled with normalizing interest rate environment set the conditions for the U.S. dollar to continue to move up compared to other currencies.

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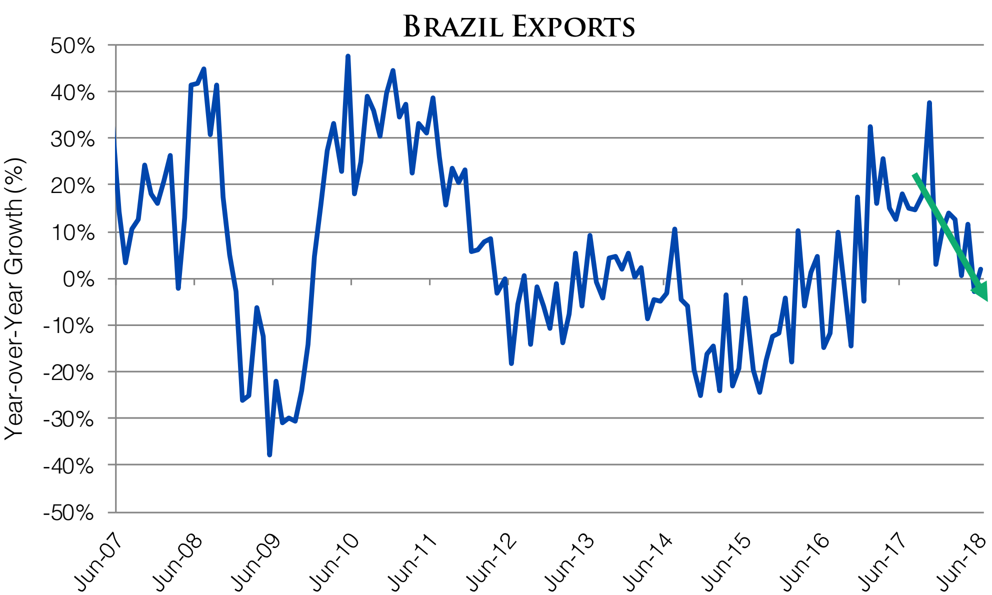
EM Fundamentals Soften in the 1st Half of 2018

Source: National Bureau of Statistics of China, WestEnd Advisors



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

While the dollar was a headwind to emerging market stocks in Q2, there have also been signs of fundamental weakness in these more economically-sensitive economies.

The Chinese economy, for example, 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. This comes after a post-recession rebound in exports that helped stabilize Brazilian economic conditions a year ago.

Portfolio Impact

Less-than-dynamic global growth and upward pressure on the U.S. dollar present challenges for emerging market equities.

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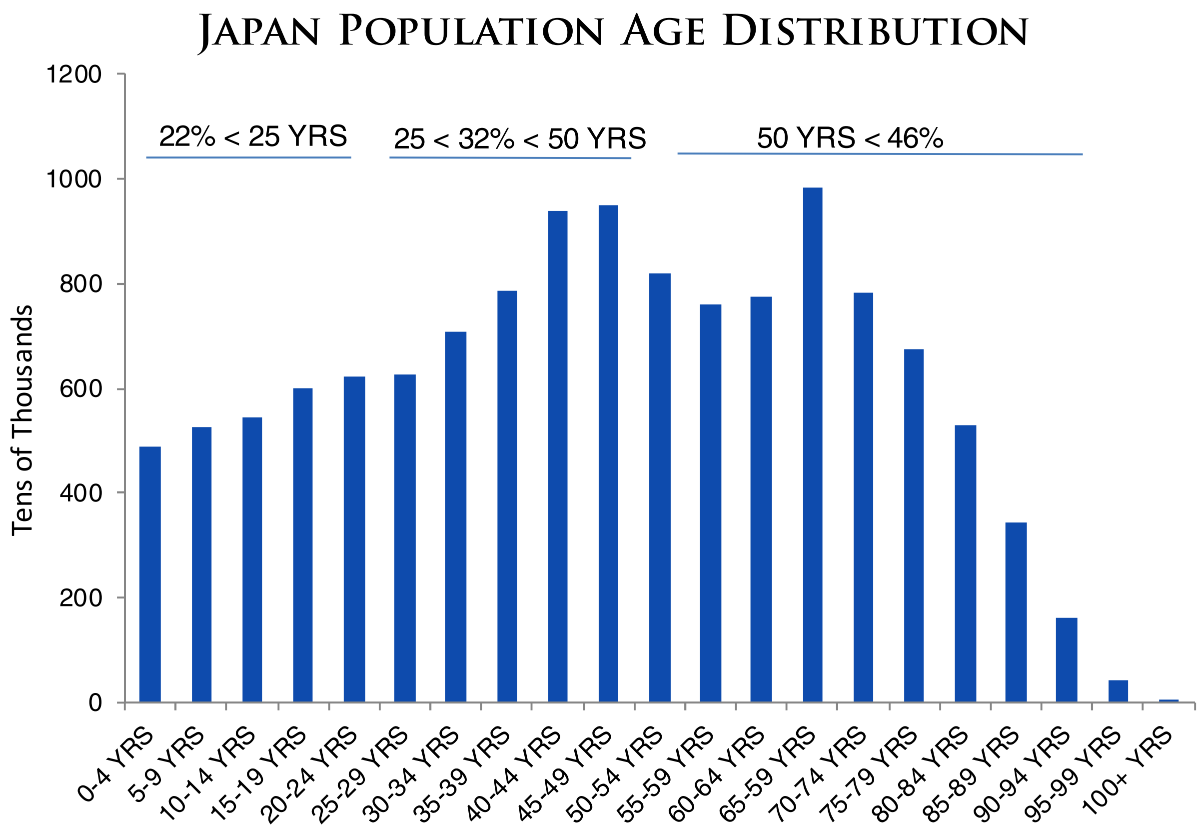
Japanese Economy Reliant on a Challenged Consumer



Source: Japan Ministry of Internal Affairs and Communications, Bloomberg, WestEnd Advisors

The Japanese economy is largely dependent on domestic consumption (over half of Japan's GDP is derived from household consumption).

A large headwind to household consumption growth is Japan's aging population. Nearly 50% of Japan's population is over 50 years old and nearly 25% is over 65. Older citizens tend to spend less while also requiring social welfare, both of which consumes public resources. An elderly workforce can also cap wages growth. The U.S. population distribution is more evenly distributed across all age groups.

Portfolio Impact

The consumer malaise in Japan is one of a series of fundamental headwinds that warrant an underweight of Japanese stocks.

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The Standard and Poor's 500 Stock Index includes 500 stocks and is a common measure of the performance of the overall U.S. stock market. 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. An index is unmanaged and is not available for direct investment.

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