Select Opportunities At Home and Abroad

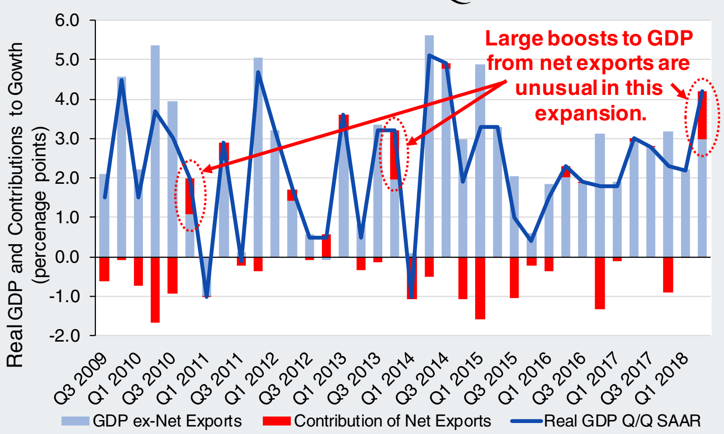
We see ongoing investment opportunities in the U.S., tied to its economic leadership. We also see new opportunities in Asia, where equity underperformance has shifted the region's risk and return outlook. While markets always face uncertainties, economic and market fundamentals appear stable.

Q3 2018 Review

The U.S. has demonstrated its relative economic strength this year. The positive economic picture in the U.S. and a reset of growth expectations for overseas economies contributed to significant outperformance in the first three quarters of the year for U.S. equities compared to international markets.

Even with favorable data, U.S. economic readings still point to moderate growth. The 4.2% GDP growth in Q2, for example, was driven, in part, by an unusual boost from exports, as illustrated in Figure 1. U.S. GDP growth on a year-over-year basis, which helps smooth out quarter-to-quarter volatility, remains below 3%. Figure 1 also shows we have seen a number of quarters with annualized GDP growth in excess of 4%, even within the moderate growth trend of the current expansion.

Figure 1: Net Exports Boosted Q2 GDP Growth



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

Overseas, developed economies continue to deliver modest economic growth. The fundamentals in emerging markets, however, have been more mixed. For example, political and economic instability in countries like Turkey and in regions like Latin America contrast sharply with the relative stability in Asian emerging market countries.

Global equity market returns varied broadly across countries and regions in Q3, but regional equity market winners largely mirrored the fundamental backdrop, which is often not the case in the short run. For example, U.S. equities posted strong performance, with the S&P 500 returning 7.7%, its highest quarterly return in eight years. It is also not surprising to see stocks pull back in early Q4 on the heels of strong Q3 returns.

Within the U.S., equity sectors that are benefitting from secular trends generally outperformed, including Health Care and Information Technology. In contrast, sectors with the most economic and interest rate sensitivity generally lagged, including Energy, Materials, Real Estate and Utilities. Industrials were an outlier among economically-sensitive U.S. sectors in Q3, outperforming as investors' concerns about trade tensions seemed to ease. Despite this bounce, Industrials continued to underperform year-to-date.

Outside the U.S., a deterioration in investor sentiment with respect to international equities, especially for emerging markets, led to their underperformance in Q3. Developed international markets posted modest gains overall, but signs of slowing growth in Europe, for instance, belied elevated investor expectations and weighed on returns. The MSCI Emerging Markets Index actually declined 1.1% in Q3, driven by a combination of continued concern over international trade tensions, signs of slower global growth, and U.S. dollar strength.

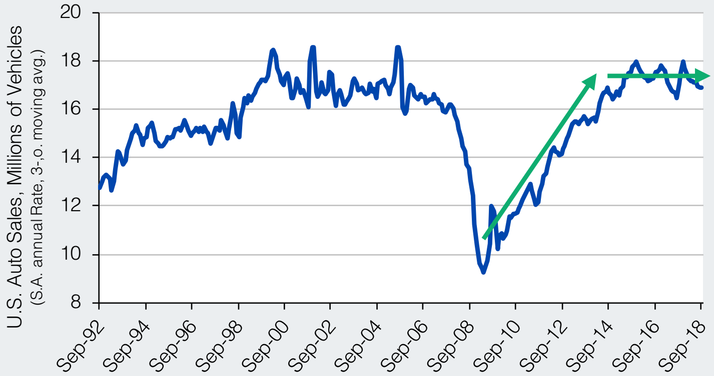
U.S. interest rates continued to rise in Q3, albeit at a slower pace than in the first half of the year. This presented a continued headwind for fixed-income returns in the quarter. Treasury bonds were particularly impacted due, in part, to their higher duration (interest rate sensitivity) relative to corporate bonds of similar maturity, and also due to shrinking credit spreads. Longer-term interest rates have moved up further in the first few weeks of Q4.

Outlook

U.S. Outlook: Our overall global economic outlook remains positive. The U.S. continues on a trend of moderate economic growth. The 4.2% annualized GDP growth for Q2 was a deviation from the multiple-year trend of 2% to 3% readings. However, other broad based measures of the U.S. economy, like the Chicago Fed National Activity Index (CFNAI), continue to point to moderate growth in Q2 and Q3, consistent with the 2.3% average annualized growth rate during the current expansion.

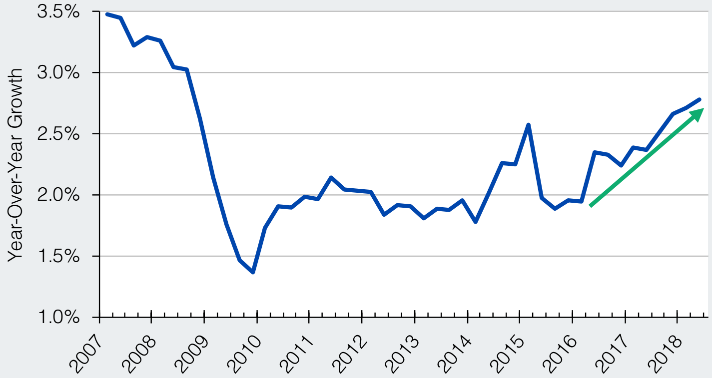
The U.S. economy has made significant progress since the cyclical trough in 2009, including a rebound in auto sales, growth in construction spending, and a tightening of the labor market. However, while auto sales (Figure 2) and construction spending remain at high levels, their growth has stalled, and unemployment has dipped well below levels economists have historically considered to represent "full employment." This suggests there is limited economic fuel to drive sustained dynamic growth going forward. However, at this point, these constraints appear to be acting more as a governor on the economic throttle rather than an outright brake for the economy.

Figure 2: U.S. Auto Sales



Source: Bloomberg, WestEnd Advisors

Figure 3: U.S. Employment Cost Index Rising



Source: Bloomberg, WestEnd Advisors

Data in Q3, meanwhile, reaffirmed our view that the consumer remains healthy and a key driver of the economy. Core retail sales growth has been trending higher, and hit 5.2% year-over-year as of August. The spending increases are supported by income growth, which is increasingly coming from gains in hourly wages, rather than additional hiring and hours worked. In fact, growth in average hourly wages reached 2.9% in August, the highest rate since mid-2009. This shift among sources of personal income is expected as the economic cycle matures. Personal income growth, which incorporates job growth as well as wage gains, was 4.7% year-over-year in August. This should support continued consumer spending.

Capturing U.S. Consumer Strength:

With consumers as a key driver of economic growth in the U.S., we believe exposure to consumer-focused U.S. equity sectors, such as Consumer Discretionary and Consumer Staples, is warranted.

There remain risks to growth in the U.S., however, even as the consumer picture is positive. For example, the flip-side of wage growth is rising costs to employers, which, in addition to dampening profitability, could eventually translate into general inflationary pressure. This, in turn, could put additional upward pressure on interest rates. As shown in Figure 3, the U.S. Employment Cost Index, which accounts for wages and other forms of employee compensation, is nearing 3% growth on a year-over-year basis.

We expect interest rates to move higher with continued modest inflation increases and potential normalization of real (inflation-adjusted) interest rates. For example, while real interest rates have remained low throughout this expansion, they have moved up recently, driving the rise in nominal long-term rates in September and early Q4. Meanwhile, the Federal Reserve continues to tighten monetary policy, which is pushing up short-term interest rates.

Positioned for Modest U.S. Growth:

We continue to favor U.S. sectors that should benefit from a mix of secular and cyclical trends, including Health Care, Info. Tech., Communication Services, and Financials.

We are avoiding the most economically-cyclical sectors, such as Industrials, Materials, and Energy; as well as the interest rate-sensitive Real Estate and Utilities sectors.

International trade policy also presents risk. We anticipate, however, that a sustained escalation in the trade dispute with China is unlikely, as deals reached with the European Union and with NAFTA trade partners suggest the Trump Administration is willing to compromise rather than suffer too great a negative economic impact. Short of a prolonged escalation of the trade dispute with China, material impacts on the U.S. economy

The New Communication Services Sector:

As previously announced, Standard & Poor's and MSCI reorganized their Global Industry Classification Standard (GICS) at the end of September 2018 to create a new "Communication Services Sector." This new sector combined the former Telecommunication Services Sector with media, advertising, and entertainment companies taken from the Consumer Discretionary Sector, and with certain internet and entertainment software companies taken from the Information Technology Sector.

We view these changes as positive for WestEnd's macroeconomic, sector-focused investment approach. Given how communications and media-related companies have evolved over the last two decades, companies within the revised sectors are now more aligned economically with each other, and there is less economic overlap across sectors. Thus, sector performance should be more responsive to distinct economic drivers that form the basis of our analysis. Additionally, the realignment reduced the size of two large sectors and increased the size of the (formerly) smallest sector, making it easier for investors to overweight or underweight those sectors, respectively.

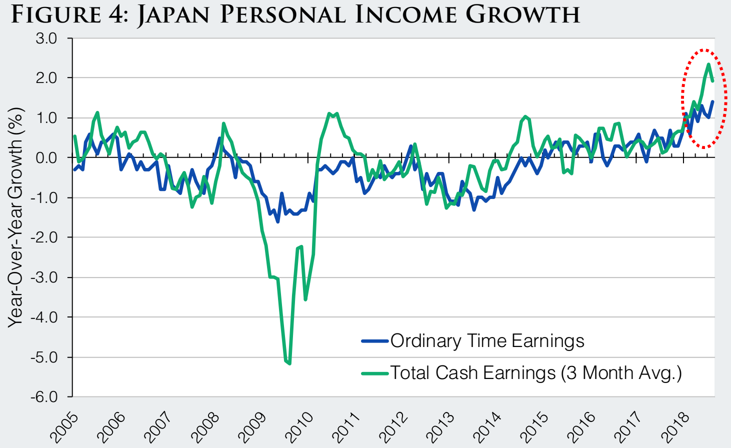
The immediate portfolio implications of the sector changes varied for different types of investments. Portfolios holding individual stocks or broad-based ETFs required no adjustment to maintain their existing economic exposure. Individual stocks held directly in portfolios or as underlying constituents of broad-market ETFs would simply be re-sorted to the new GICS sectors. In contrast, our ETF portfolios utilize sector-focused ETFs to gain U.S. equity exposure, and the underlying holdings of ETFs tied to the revised sectors changed as the revisions were implemented. We adjusted portfolios accordingly in late Q3 to maintain our desired fundamental U.S. equity exposures.

should be limited to specific segments, such as manufacturing and agriculture, given the positive U.S. fundamentals.

Another source of uncertainty is the upcoming midterm elections. While we are not making a prediction on whether Republicans lose control of one or both houses of Congress, the specific degree of the outcome is less important than directional shift in power. Democrats are likely to gain seats in the House. A pickup of seats in the Senate is less likely, however, given the number of Democratic incumbents running for reelection in states President Trump won in 2016. With a Republican President and less-than-overwhelming Republican majorities in Congress, any Democratic gains would reduce the government's already-limited ability to pass major legislation. Thus, absent surprise strength by Republicans, the net result of the elections should increase gridlock and have limited impact on our broad outlook.

International Outlook: Outside the U.S., European economies remain constrained by structural challenges, such as Italy's debt load, and have recently shown signs of cyclical headwinds. Euro Area GDP growth has slowed notably so far this year compared to 2017. In contrast, in Asia, the long-suffering Japanese economy is showing some signs of improvement, including improved personal income growth (Figure 4) and a pickup in business capital expenditures on the back of increased corporate profitability.

Figure 4: Japan Personal Income Growth



Source: Bloomberg, WestEnd Advisors

Economic growth in some key emerging economies, like China, has been slowing for some time. Still, economic growth rates are notably higher in emerging markets, on average, than in developed markets. Asian economies, in particular, should continue to benefit from positive secular drivers. There has been a fundamental shift over the last decade in the composition of economic activity in these markets, and Information Technology is now the largest equity sector within Asian emerging markets. This gives emerging Asia a fundamentally different profile than emerging markets in other regions, such as Latin America, where commodity-related industries are key drivers. Thus, Asian emerging markets should receive a tailwind from many of the same long-term trends that are benefitting the Information Technology sector in the U.S.

While the global economic picture has not shifted dramatically this year, a deterioration in investor sentiment toward international equities, and especially emerging markets, has led to a significant valuation discount of certain international equities compared to U.S. stocks. Asian equity markets, in particular, are at essentially all-time low P/E valuations compared to U.S. stocks.

Increased Asian Equity Exposure:

We believe underperformance of Asian equities this year has reduced their risk relative to the region's fundamentals. As such, we increased Asian equity exposure in global portfolios in Q3, funded by a modest decrease in our U.S. overweight. We maintain a very positive view toward the U.S.—particularly the select U.S. sectors to which we have current allocations—and had been at the upper bound of our allowable U.S. large-cap equity allocations over the past year.

In our view, some of the concerns that have weighed on emerging markets are overdone. Trade tensions, for example, are likely to ease. If they do, Asian stocks should benefit, and the U.S. dollar is likely to weaken, which would provide an additional tailwind for emerging markets. If, on the other hand, trade tensions continue or intensify, they should pose less of an economic headwind than is widely anticipated. China, for example, is the primary target of U.S. tariffs, but only about 19% of Chinese exports go to the U.S. The Chinese government is also likely to take measures that can mitigate some of the negative economic impact of tariffs, while other emerging markets in Asia are likely to benefit if trade shifts away from China. We recognize there are material risks associated with shifting U.S. trade policy, but we currently believe equity markets have substantially discounted those risks, which makes the risk/reward profile of emerging Asian stocks much more attractive today than at the beginning of the year.

Conclusion

We expect moderate economic growth will continue in the U.S. and abroad into 2019. Our portfolios are positioned in U.S. sectors that benefit from certain cyclical trends, such as U.S. consumer strength, as well as secular trends, like the shift to digital media. We continue to manage portfolio risk, in part, through avoidance of the most economically-sensitive U.S. sectors and, in balanced portfolios, by limiting exposure to longer-duration fixed-income securities. We have also made minor allocation adjustments in our global strategies to take advantage of expected improvement in sentiment toward Asia, where we now view valuations as misaligned with fundamentals.

We remain vigilant in our analysis of global macroeconomic and market conditions. As we write this, an uptick in market volatility is highlighting a range of investor uncertainties, but does not change our fundamental outlook. Please feel free to contact us with any questions on our outlook or portfolios, and thank you for your continued interest in WestEnd Advisors.

WestEnd Advisors Investment Team | October, 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 Emerging Markets Index represents a subset of the MSCI ACWI, comprising 24 emerging market country indexes. 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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