2018 – Markets Shaken, Economy Not Stirred

Global capital markets saw a resurgence of volatility in 2018, as rising interest rates and geopolitical risks shook investor confidence. However, broad economic trends remained fairly stable, and the relative returns of various market segments in 2018 largely lined up with our macro outlook.

As we begin a new year, we would like to briefly highlight what we view as some of the key economic and market developments in 2018, and, where relevant, how these developments impacted our ETF portfolio allocation decisions (see call-out boxes). We will publish our regular 2019 outlook in mid-January.

U.S. Economic Trends Remained Stable

U.S. economic activity was mixed in 2018. GDP readings in Q2 and Q3 were higher than we specifically anticipated in 2018, but factors like construction and auto sales plateaued. Still, the trajectory of economic growth remained moderate, with about three percent real GDP growth year-over-year.

Market Volatility Returned

At the start of 2018, we anticipated that forward P/E valuations would fall as investor expectations incorporated a one-time boost to earnings growth tied to 2017 tax reform. The downward revaluation we expected began fairly early in the year, as equities pulled back and volatility spiked in Q1. A second pullback began at the end of September, with increased volatility through the end of the year amid rising interest rates, downward revisions to future earnings estimates, and continued international trade tensions. This pushed equity valuations significantly off of their 2017 highs, but the issues driving short-term volatility, while legitimate risks, were not out of line with our generally favorable market outlook.

Capturing U.S. Consumer Strength Amid Volatility:

Jun. 2018 – Shifted U.S. Cons. Staples to an active overweight and modestly reduced our U.S. Health Care overweight as volatility provided an opportunity to reallocate within our less-economically-sensitive portfolio exposures.

Amid 2018's volatility, large-cap U.S. sectors benefitting from secular trends generally outperformed, including Health Care and Consumer Discretionary. In contrast, more economically-sensitive sectors lagged, including Energy, Materials, and Industrials, partly reflecting sensitivity to international trade fears.

A New Sector: Communication Services

Another notable event in 2018 was the creation of a new Communication Services Sector within MSCI and S&P's Global Industry Classification Standard. At the end of September, the former Telecom. Services Sector was renamed and expanded with the addition of certain companies taken from the Information Technology and Consumer Discretionary Sectors.

Adapting to the New Communication Services Sector:

Sept. 2018 – Adjusted U.S. equity sector allocations to maintain fundamental exposure as holdings within ETFs shifted to reflect GICS sector changes.

While this sector reorganization had little immediate economic or market impact, we see it as a positive for our sector-based U.S. investment approach. The composition and size of the new sectors should make them more responsive to distinct economic drivers and enhance opportunities for active allocation.

Interest Rates Rose

Rising interest rates were a key macroeconomic factor for markets in 2018. Over the course of the year, the 10-year Treasury yield rose 28 basis points, in part due to a normalization of real, or inflation-adjusted, interest rates. Meanwhile, short-term rates, as measured by the 3-month T-bill rose 106 basis points, as the Federal Reserve has continued to raise its Federal Funds target rate for overnight bank lending. Not only did rising rates drive weak or even negative returns in U.S. fixed income markets in 2018, but we believe they were also a primary driver of resurgent equity market volatility during the year. Rising rates also likely supported U.S. dollar appreciation versus most major foreign currencies, which exacerbated international equities' underperformance for U.S.-based investors in 2018.

Fine-Tuning Our Short Duration:

March 2018 – Shifted short-term fixed-income exposure toward investment-grade floating-rate bonds from TIPS after inflation expectations rose materially.

International Underperformed

Despite optimistic investor sentiment toward international equities at the beginning of 2018, our fundamental outlook led us to underweight international equities throughout the year. As 2018 progressed, investor sentiment deteriorated sharply and international equities materially underperformed. Emerging Asia equities, in particular, reached near-all-time low P/E valuations compared to the U.S.

Seeing a Risk/Reward Profile Shift in Asia:

September 2018 – Increased Asia exposure (reduced the degree of underweight), as lower valuations diverged from fundamental improvements and limited impact of trade tensions.

Developed economies outside the U.S. generally continued to deliver modest economic growth, though fundamentals were mixed in 2018. For example, Euro Area GDP growth slowed in 2018 compared to 2017 amid concerns over issues like Italy's debt load and Brexit. In contrast, the Japanese economy showed some signs of improvement, including a pickup in wage growth and increased business capital expenditures. In emerging markets, political and economic instability in countries like Turkey and in regions like Latin America contrasted sharply with the relative stability in Asian emerging market economies.

WestEnd Advisors Investment Team | January 2, 2019

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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.

At the end of September 2018, Standard & Poor's and MSCI reorganized their Global Industry Classification Standard (GICS) 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.

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.