Sound and Fury Versus Sound Fundamentals

A range of concerns shook investor confidence and markets in 2018, yet broad economic trends point to continued moderate growth. Our market outlook remains positive, given the disparity between global economic fundamentals and sharply reduced equity valuations.

2018 and Q4 Review

The return of equity market volatility and weak returns across asset classes defined markets in 2018. Volatility increased markedly in comparison to the market calm of 2017. For example, in 2018, the S&P 500 Index had the most daily moves of plus-or-minus 2% since 2008, while 2017 had the fewest absolute moves of greater than 1% in 50 years. Also, as has been widely noted, December 2018 was the single worst performance month for the S&P 500 since the end of the 2008 financial crisis. Rising interest rates, falling earnings expectations, geopolitics (e.g. international trade issues, Brexit uncertainty, etc.), and, ultimately, concerns over slowing economic growth all played a role in shaking investor confidence.

Last year was also unusual for uniformly low returns across asset classes. For the first time in over two decades, all major asset classes underperformed U.S. inflation in 2018. *Relative* returns for many market segments, however, lined up with our outlook for the year as a whole (despite some leadership shifts and an interest rate pullback in Q4). The S&P 500 posted its first negative total return (-4.4%) since 2008, but still outperformed equities in nearly every major international region. Emerging market (EM) equities, in aggregate, were among the worst performers, with the MSCI EM Index posting a -14.2% return for the year in U.S. dollars, despite outperformance for EM in Q4.

Amid 2018's volatility, large-cap U.S. sectors benefitting from secular trends generally outperformed, including Health Care and Information Technology. The interest rate-sensitive Utilities and Real Estate Sectors also outperformed for the year due to strong relative performance in Q4 as interest rates pulled back. In contrast, more economically-sensitive sectors lagged sharply in 2018. Materials and Industrials underperformed, partly reflecting sensitivity to international trade fears, but Energy was the worst-performing U.S. sector in 2018, as oil prices declined about 25%.

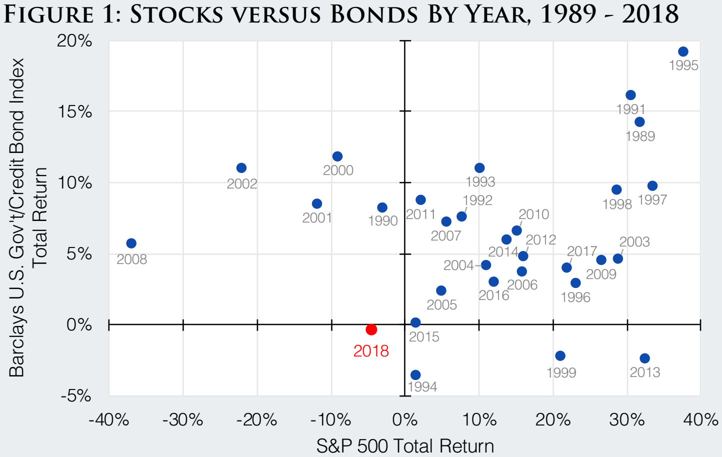
U.S. Treasury securities were one of the few asset classes to post even modestly positive returns in 2018, with the Barclays U.S. Treasury Index returning less than 1% for the year. While we did not anticipate Treasury outperformance, short-duration fixed-income securities did outperform longer-term securities, as rising interest rates negatively impacted prices for long-duration bonds and short-duration fixed-income offered improved yields.

While financial markets saw increased volatility and weak returns in 2018, U.S. economic trends remained healthy. The U.S. had two quarterly GDP growth readings above 3%, yet moderate year-over-year growth trends continued. European economic growth, in contrast, disappointed relative to elevated consensus expectations at the start of 2018, as we had expected. Asia showed economic resilience in the face of international trade pressures on China and natural disasters in Japan and elsewhere.

2019 Outlook

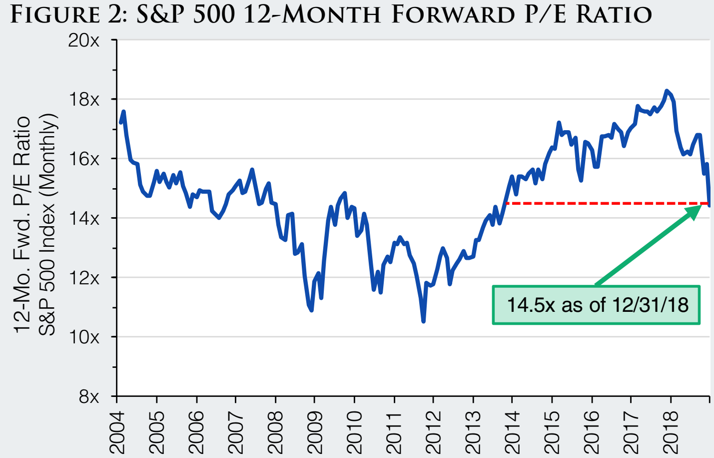
Despite the sharp market volatility at the end of 2018 and investor concerns that trade disputes will dampen economic growth, we expect moderate U.S. economic growth to continue in 2019, and possibly beyond. The sharp market pullback at the end of 2018, together with the moderate economic backdrop and healthy earnings growth prospects, leads us to believe the U.S. equity market outlook is more favorable, on balance, than a year ago. In fact, the 12-month forward P/E ratio of the S&P 500 Index had fallen to 14.5x at year-end, in line with 2013 levels.

Figure 1: Stocks versus Bonds By Year, 1989 - 2018



Source: Bloomberg, WestEnd Advisors

Figure 2: S&P 500 12-Month Forward P/E Ratio



Source: Bloomberg, WestEnd Advisors

U.S. Economy Normalizing for Late Expansion: As we anticipated following the 2016 elections, Republican policies like tax cuts and regulatory reform have extended the economic cycle with continued moderate growth and reduced the risk of recession. These policies have not, however, driven a material and sustained reacceleration of economic growth. As we have also been saying since before the 2016 election, the drawn-out length of this economic expansion has already relieved much of the pent-up demand that could have fueled more dynamic economic growth trends.

Meanwhile, the benefits from policy changes now appear to be fading. Corporate earnings growth rates are returning to a more normal level for late in an expansion, following the one-time boost in 2018 from the 2017 tax reforms. Business CapEx growth, which saw limited benefit from tax law changes, softened in the second half of 2018. This leaves the economy in much the same place it was in mid-2016, pre-election, with room for continued moderate growth, but also signs of a maturing cycle.

Nonetheless, we remain confident that the moderate economic expansion should continue, despite its age. Consumer strength remains a highlight of the U.S. economy. Overall consumer spending growth has been trending higher since the end of 2015, and a combination of income growth, the tight labor market, and elevated savings rates provide fundamental support that should drive continued spending in 2019. Consumers de-leveraged after the 2008 financial crisis and have not overstretched to drive spending. In fact, consumer's debt service and other financial obligations (e.g. rent, auto lease payments, property taxes, etc.) have remained lower this cycle, as a percentage of disposable income, than at any point since 1984. U.S. corporations also appear to be on solid financial footing. Corporate profits are healthy, with S&P 500 companies posting operating margins near all-time highs. This suggests companies can weather some economic softness.

Select U.S. sectors provide opportunity as growth continues: At the start of 2018, we had anticipated that forward P/E valuations would fall as investor expectations looked past the one-time boost to earnings growth tied to 2017 tax reform. With the additional impact of the market pullbacks, U.S. valuations are now very attractive, given our outlook for a relatively stable economic environment. In particular, sectors with earnings growth drivers that are not reliant on dynamic early-cycle economic growth should continue to outperform, while more economically-sensitive sectors continue to present a high risk of falling short of investor expectations.

U.S. Equity Exposure:

We favor U.S. sectors with a mix of positive secular and cyclical tailwinds, including Info. Tech., Communication Services, and Health Care. We are avoiding the most economically-cyclical sectors, like Industrials and Energy.

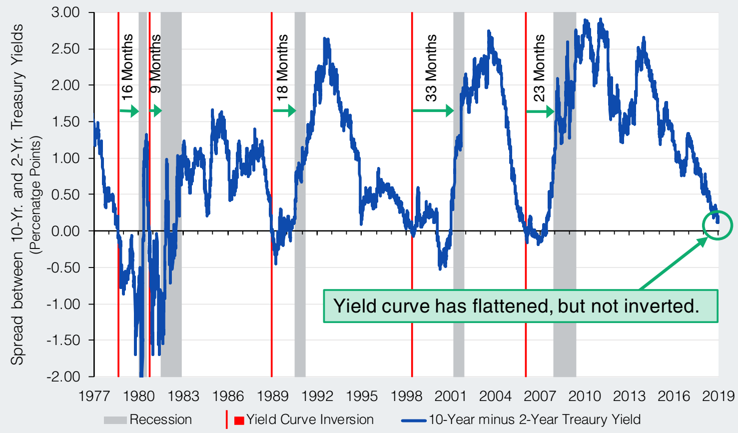
Normal cyclical risks: We recognize that risks have increased from a year ago, but they are not extreme, in our view. Many key risks today are typical of late-stage economic cycles, including challenges for businesses from cost pressures and softness in interest rate-sensitive parts of the economy like construction and autos.

Prepared for More Upward Pressure on Interest Rates:

We are emphasizing short-duration and floating-rate securities within fixed-income allocations, and we continue to avoid the most interest rate-sensitive U.S. equity sectors, like Utilities and Real Estate.

The flattening of the yield curve, as measured by the spread between 2-year and 10-year Treasury bonds, is another normal risk late in the economic cycle. We believe recent investor and media concerns over the potential for a yield curve inversion are premature, not only because inversion has yet to occur, but because inversion of the yield curve has historically been a leading, rather than a coincident indicator of recession. Over the past five economic cycles, there has been an average of over 20 months from the time the curve first inverts to the start of a recession. In our view, the current positive yield curve, though much flatter than a year ago, is more indicative of a late-cycle expansion with room to run than of an impending recession or extended bear market.

Figure 3: Treasury Yield Spread and Recession



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

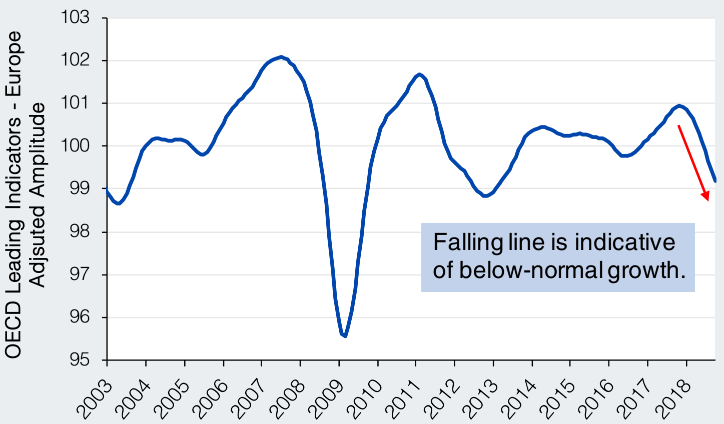
Further, the likely trajectory of interest rates reduces the risk of near-term yield curve inversion. We expect the recent pullback in longer-term interest rates will reverse as investors' concerns over economic growth abate. Additionally, the Federal Reserve (the "Fed") appears likely to slow or halt short-term interest rate hikes in 2019. Prior to the Fed's December rate hike, Fed Chairman Jerome Powell noted that the Fed Funds target rate was at the low end of its "neutral" level with respect to its impact on economic growth. Comments by Powell and other Fed officials after the December FOMC meeting indicated the Fed would be "patient" with regard to hikes in 2019, and markets currently appear to be anticipating no rate hikes at all in 2019.

Risks particular to this cycle: This cycle also has unique risks, perhaps most notably the rise in international trade tensions, but also more general political uncertainty in the U.S., and the artificial deceleration of earnings growth following the tax change-driven boost of 2018. While a continued impasse or escalation on trade with China could take a toll on economic growth, we currently believe that de-escalation is likely. Neither the U.S. nor China wants to endure sustained economic headwinds from trade disputes. If recent history is any guide, escalating rhetoric and tough policy stances by the U.S. Administration are negotiating tactics that set the stage for it to claim successes when some de-escalation or concessions are achieved.

There are also important offsetting factors to fundamental risks, not least of which is that overall economic momentum is still positive in the U.S. Additionally, political gridlock following the Democratic takeover of the House of Representatives should reduce legislative risks. Further, from an equity market perspective, reduced valuations compared to a year ago (or even a month ago) should provide some downside protection for stocks as economic growth continues.

International economic trends shifting slowly, still lag U.S.: The international economic and geopolitical picture has evolved on the margin. In Europe, economic growth should remain positive in 2019, but it is likely to be slower than the U.S. and slower than it was in 2018. Economic and political uncertainty in Europe is a concern again for investors compared to the start of 2018. In addition to ongoing uncertainty over Brexit and ECB monetary policy, political unrest in France and Italian debt concerns present additional risks to economic fundamentals and investor sentiment. While European stock market P/E levels already seem to account for some uncertainty, we do not see a fundamental catalyst for an upward move in valuations.

Figure 4: OECD Leading Indicators - Europe



Source: OECD, Bloomberg, WestEnd Advisors

In Asia, Japan should see positive, albeit slow growth. While Japan posted negative real GDP growth in Q3 2018, that decline reflected the impact of several natural disasters, which should prove temporary. Japanese wage data and increased corporate profitability are indicative of moderately positive economic trends, while fundamental risks are well known. For example, risks from a looming sales tax hike in Fall 2019 are likely already priced into the market, and the government has articulated plans to offset its economic impact. Thus, Japan's continued economic growth, coupled with low valuations, presents a relatively attractive risk/return profile.

> **Limiting Risks Internationally:**
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> *We continue to underweight European equities, where economic growth trends are unlikely to improve in the near-term. We see better international opportunities in Asian equities, where declining relative valuations have improved the region's risk/reward profile.*

More broadly in Asia, the potential for easing trade tensions could provide relative upside to the region's heavily discounted valuations, especially for Asian emerging markets. Despite some recent signs of economic slowdown, we believe China should ride out the trade storm. International trade should be supported by a weaker renminbi, and government stimulus meant to help offset trade issues should contribute to growth over time. We believe Chinese valuations have overshot fundamentals to the downside, as illustrated by China's tech sector, which is trading at a P/E of less than 10x and stands at a historic discount to the U.S.

Conclusion

The sharp volatility and weak returns of 2018 have understandably rattled investors' nerves. However, our macroeconomically-driven investment approach is highlighting the current disparity between reasonably positive economic fundamentals and the recent sharp downward shift in equity valuations. We see opportunity for select sectors in the U.S. and reduced market risk in various international regions as the global expansion continues in 2019. We believe our portfolios are well-positioned for the environment ahead, and we look forward to providing updates on our outlook and the markets as the year progresses.

As always, we appreciate our clients' confidence in WestEnd and welcome any questions you may have on our outlook or portfolios.

WestEnd Advisors Investment Team
January 15, 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. The Barclays U.S. Government/Credit Index measures performance of U.S. dollar denominated U.S. Treasuries, government-related, and investment-grade U.S. corporate securities that have a remaining maturity of greater than or equal to 1 year. In addition, the securities have $250 million or more of outstanding face value, must be fixed-rate, and non-convertible. An index is unmanaged and is not available for direct investment.

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