WestEnd Advisors

Q1 2019

WestEnd Advisors

Macroeconomic Highlights

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WestEnd Outlook Highlights

- Global economic growth should continue in 2019, despite headwinds from trade disputes, with positive momentum in the U.S. and mixed economic trends internationally.
- In the U.S., positive employment and wage trends should support continued healthy consumer spending in 2019, while strong earnings growth in 2018 and the recent market pullback make U.S. valuations attractive amid moderate economic growth.
- We favor U.S. equity sectors benefitting from a mix of secular and cyclical tailwinds, including Information Technology, Communication Services, and Health Care; we continue to avoid the most economically-sensitive U.S. sectors, like Industrials and Energy, as well as the interest rate-sensitive Utilities and Real Estate Sectors.
- While European GDP growth should remain positive in 2019, major E.U. economies are seeing growth slow in the face of structural, cyclical, and political challenges.
- Asia's economic outlook is mixed, as slow-but-improving economic trends in Japan contrast with economic deceleration in China, but Asian markets now have relatively attractive valuations and stand to benefit as trade tensions ease.

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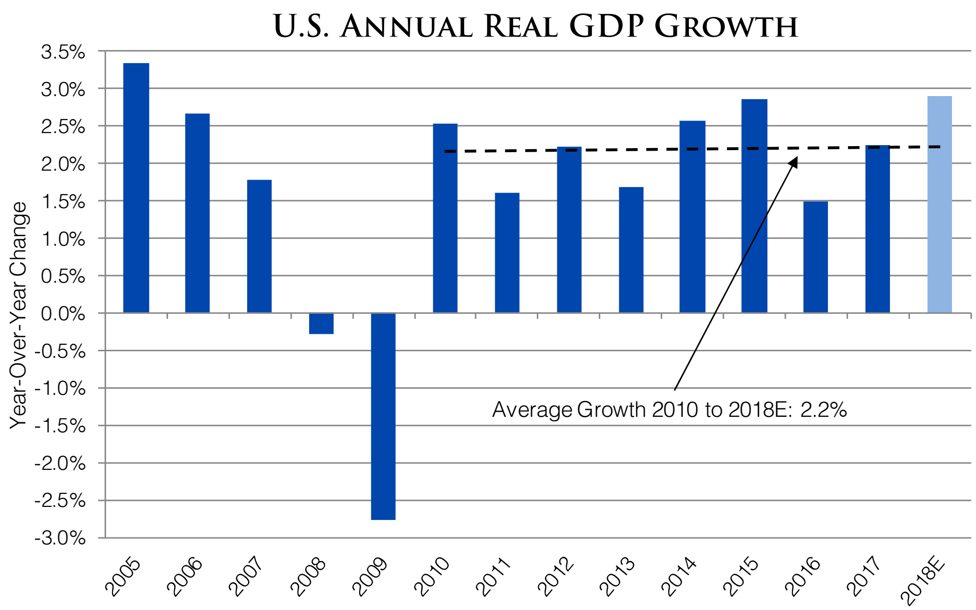
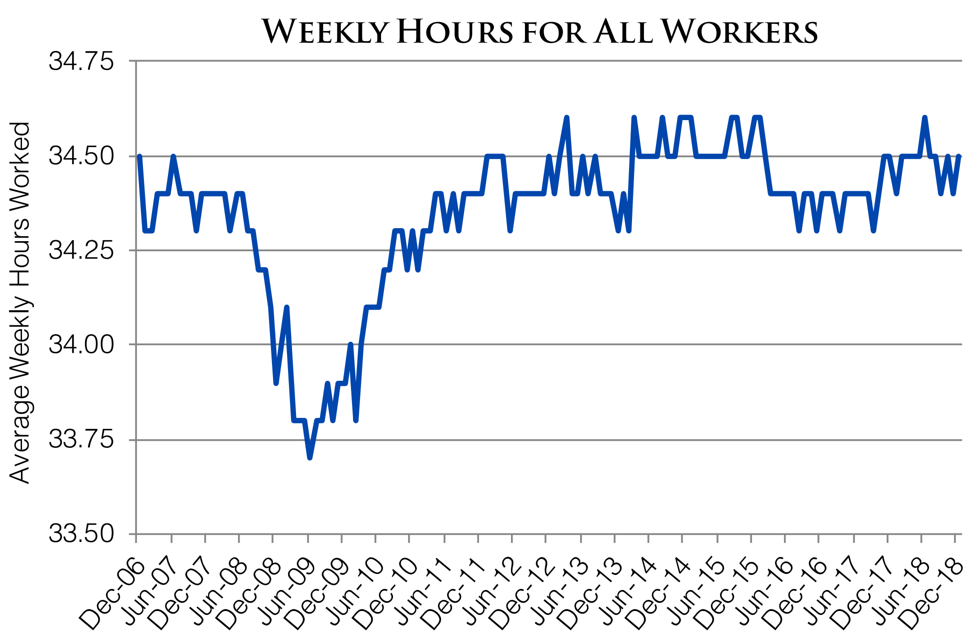
U.S. Economic Backdrop

U.S. Economy Moves Forward Amid Financial Market Volatility



Source: Bureau of Economic Analysis, WestEnd Advisors



Source: Bureau of Labor Statistics, WestEnd Advisors

Portfolio Impact

Technology & Health Care Sectors:

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

Industrials & Materials Sectors:

Avoid sectors that typically benefit from dynamic economic growth.

Economic readings have remained healthy overall even as the financial markets experienced a period of elevated volatility in Q4.

Consumer strength has been key to U.S. growth. We expect that Real GDP grew about 2.9% in 2018.

Other broad measures of economic activity also point to steady growth. The December reading on hours worked per employee showed a modest increase for the month.

We see the U.S. economy on track for another year of moderate growth in 2019, albeit the pace of growth will likely be down from what was achieved in 2018.

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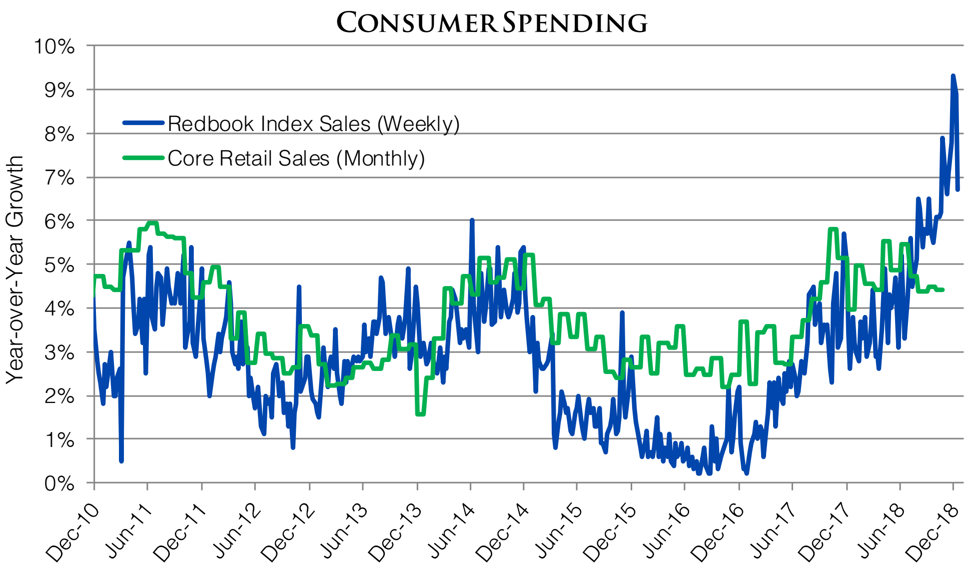
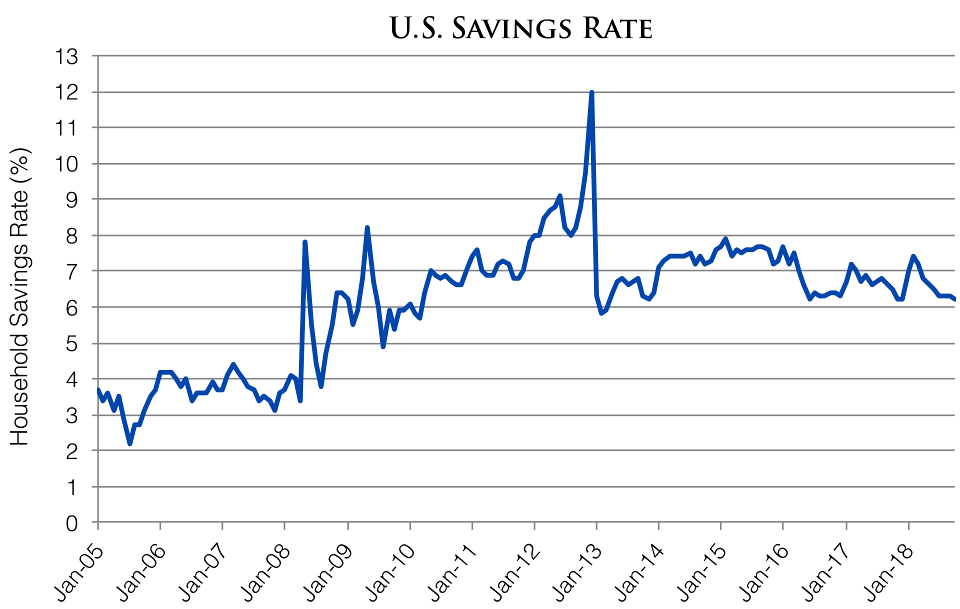
U.S. Consumer Supports Economic Fundamentals



Source: U.S. Census Bureau, Redbook Research, WestEnd Advisors



Source: Bureau of Economic Analysis, WestEnd Advisors

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.

Consumer spending was strong during the holiday season despite the financial market volatility during Q4.

Core retail sales grew over 4% year-over-year in the first two months of Q4, and weekly Redbook Sales indicate that the pace of spending may have increased further in December.

Income gains for individuals are near cyclical highs. <u>This income growth together with near record-low layoffs and an elevated savings rate should provide fuel for spending gains in the year ahead.</u>

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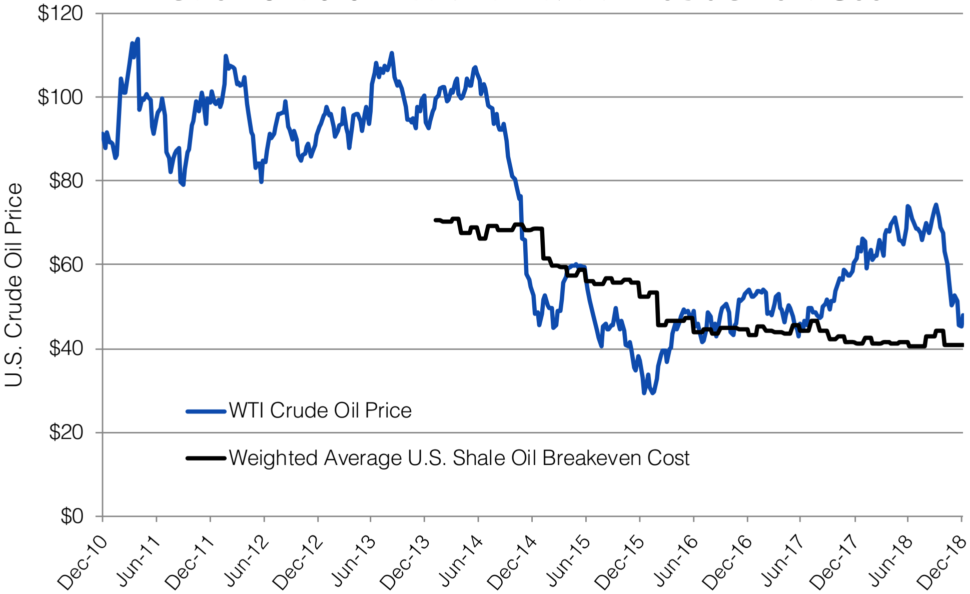
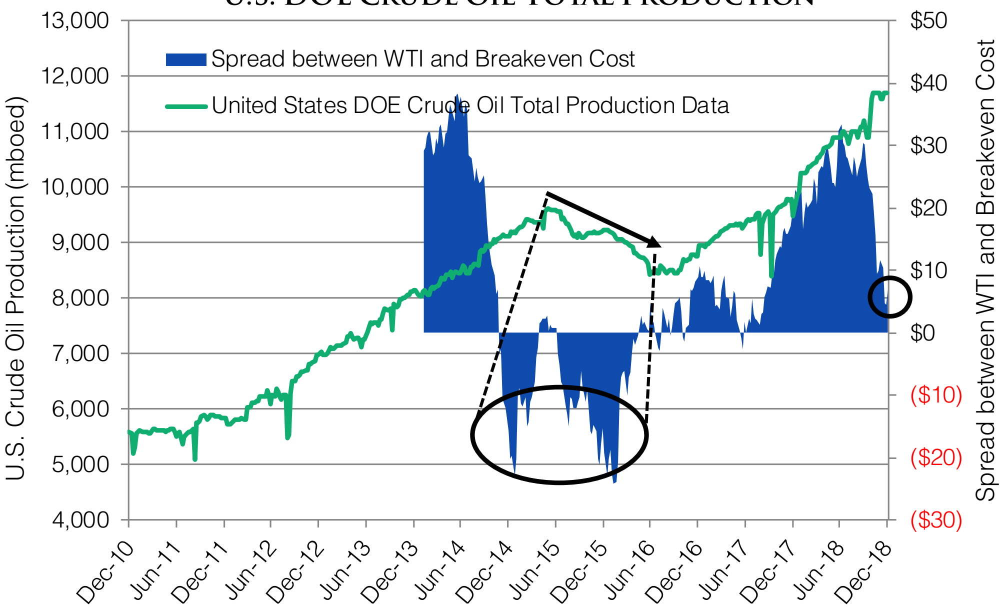
Energy Sector Challenges Likely to Persist

Price of Oil & Shale Breakeven Production Cost



Source: Bloomberg, Rystad Energy, BTU Analytics, WestEnd Advisors

U.S. DOE Crude Oil Total Production



Source: U.S. Department of Energy, Rystad Energy, BTU Analytics, WestEnd Advisors

Portfolio Impact

A low likelihood of dynamic economic growth together with a challenged earnings outlook and extended valuations leads us to believe the risks outweigh the opportunities in the Energy Sector.

Crude oil prices fell in Q4 as oil inventories increased on the back of continued oil sales by Iran and increased shale production in the U.S. Prices were also hurt by global growth concerns.

Despite the price decline of West Texas Intermediate (WTI) crude late last year, <u>the price for WTI remains above the average breakeven cost for shale producers</u> (top chart).

This cost dynamic, together with the fact that new wells have even lower breakevens, indicates that it is unlikely we will see a material decline in shale oil production like what occurred in 2015 when WTI fell well below the average breakeven cost (bottom chart).

Thus, continued record U.S. shale production is likely to weigh on crude oil prices and Energy Sector earnings.

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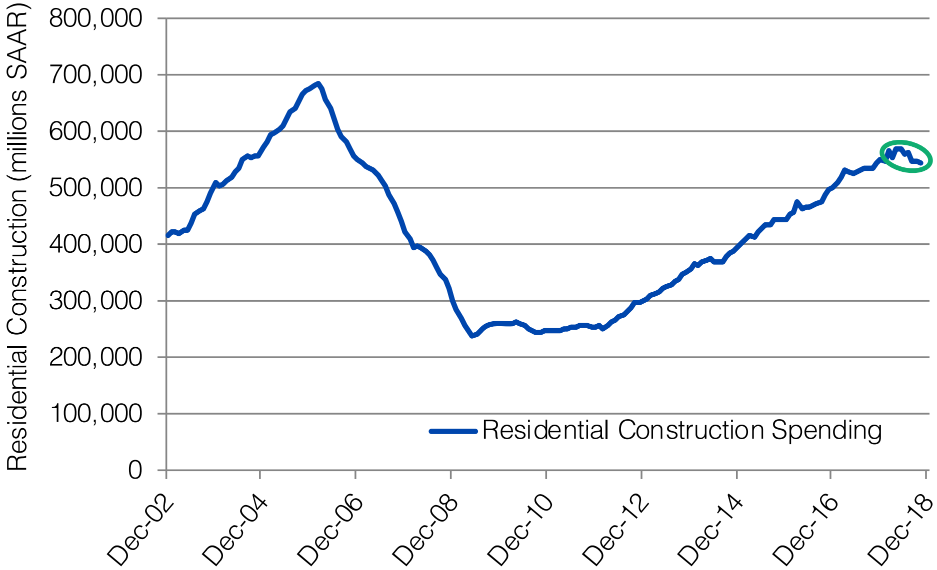
INCREASED RISKS IN 2019 VS. 2018: *TYPICAL CYCLICAL CHALLENGES*

U.S. RESIDENTIAL CONSTRUCTION



Source: U.S. Census Bureau, WestEnd Advisors

EMPLOYMENT COST INDEX

Source: Bureau of Labor Statistics, WestEnd Advisors

PORTFOLIO IMPACT

Progress in the U.S. economic cycle warrants avoiding certain segments of the financial markets, including Energy and Materials Sector stocks, small-cap stocks and high-yield bonds that benefit from more dynamic growth.

The economy has made significant progress since the cyclical trough in 2009 as key areas like auto sales and construction spending have improved from their lows.

As seen in prior cycles, these same areas of the economy often struggle as interest rates move higher. The 10-year Treasury yield pulled back in Q4, but is still up 1.3 percentage points from its 2016 low.

Another normal characteristic of a maturing economic cycle is a tight labor market, which typically contributes to cost pressures for businesses. The Employment Cost Index in its latest reading was up 2.8%, the largest annual increase since 2008.

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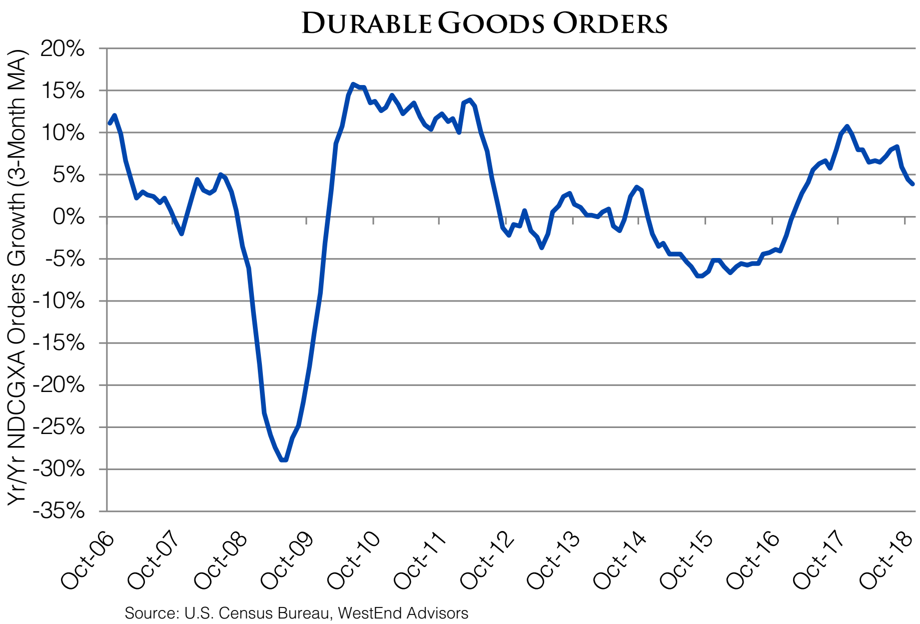
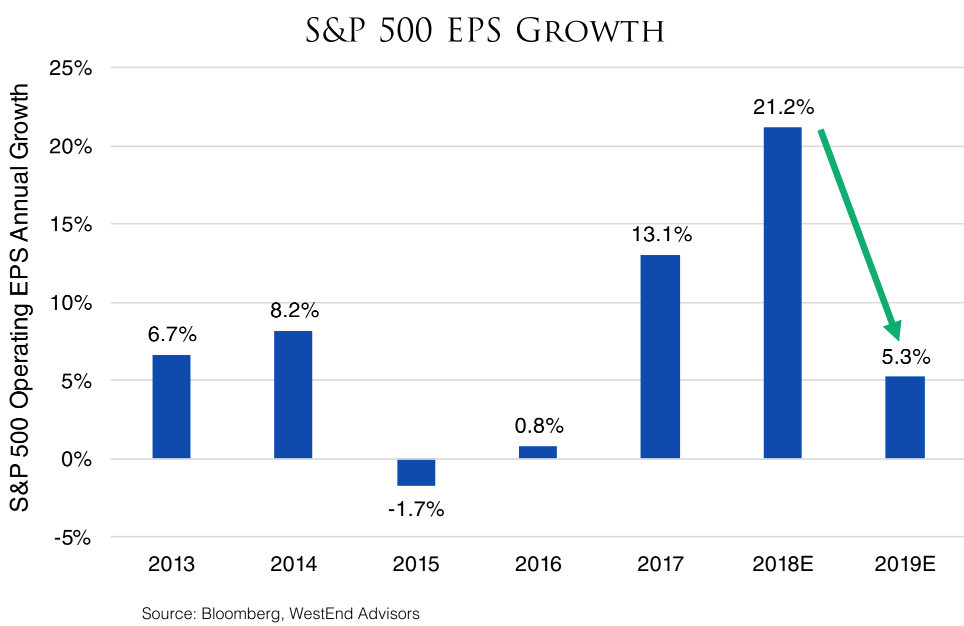
Increased Risks in 2019 vs. 2018: *Challenges Particular to this Cycle*





Portfolio Impact

We recognize the potential for escalating trade disputes, but we currently see the U.S. impact as limited to specific segments of the economy like manufacturing and agriculture. We are avoiding Industrials Sector exposure due to the lack of strong economic growth, but it is also a sector with significant exposure to the ongoing trade disputes.

<u>The trade tensions between the U.S. and China are a risk specific to the current cycle.</u>

We have not avoided Industrials because of their exposure to a trade war, but we do think trade concerns have weighed on business sentiment in the second half of 2018. This has contributed to slower business investment (top chart) and provided another headwind for Industrials.

Another area of concern for investors particular to this cycle is the deceleration in after-tax profit growth in 2019. A large portion of the shift down is attributable to the one-time benefit of tax reform in 2018.

Still, investors have concerns when EPS growth slows markedly in a mature economic cycle.

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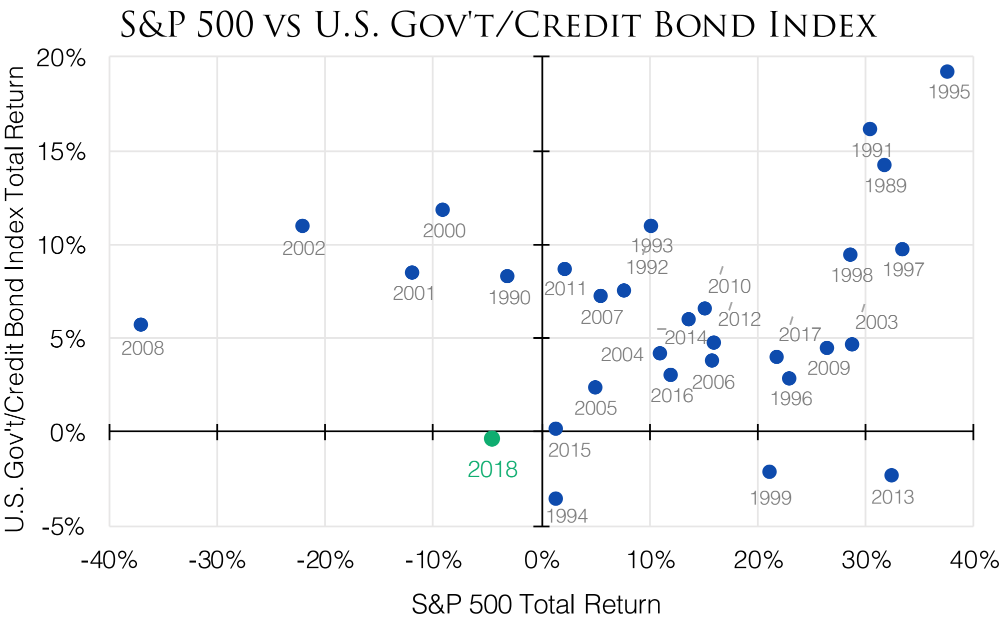
Low Returns Across Asset Classes Indicative of a Maturing Cycle



Source: Bloomberg, WestEnd Advisors

Asset Class	2018 Total Return	Proxy Index
U.S. CPI Inflation Estimate*	2.2%	CPI All Urban Consumers
U.S. T-Bills	1.8%	Barclays 1-3 Mo. Treasury Bill Index
Mortgage-Backed Securities	1.0%	Barclays U.S. MBS Index
U.S. Treasury Bonds	0.9%	Barclays U.S. Treasury Index
Corporate Bonds	-2.5%	Barclays U.S. Corporate Bond Index
Aggricultural Commodities	-3.6%	BBG Agricultural Index (Spot)
Precious Metals	-3.8%	BBG Precious Metals Index (Spot)
U.S. Large-Cap Equities	-4.4%	S&P 500 Index
U.S. Small/Mid Cap Equities	-10.0%	Russell 2500 Index
Int'l Developed Market Equities	-13.6%	MSCI World ex-US Index (USD)
Emerging Market Equities	-14.5%	MSCI Emerging Markets Index (USD)
Energy Commodities	-16.3%	BBG Energy Index (Spot)
Industrial Metals	-20.2%	BBG Industrial Metals Index (Spot)

** Inflation Estimate based on year-over-year change in CPI index as of November 2018.*
Source: Bloomberg, WestEnd Advisors

Source: Bloomberg, WestEnd Advisors

Portfolio Impact

A more advanced economic cycle demands being selective within both equity and fixed income asset classes to identify attractive investment opportunities.

A return of equity market volatility and weak returns across asset classes defined markets in 2018.

The consistency of low returns across asset classes in 2018 was unusual – it was the first time in over two decades that all major asset classes underperformed U.S. inflation.

We see the low return environment as consistent with a maturing economic cycle. Interest rates trending higher produces low fixed income returns, while equity investors digest less compelling earnings growth compared to earlier in the cycle.

Nevertheless, we still see compelling opportunities in select areas of the financial markets for 2019.

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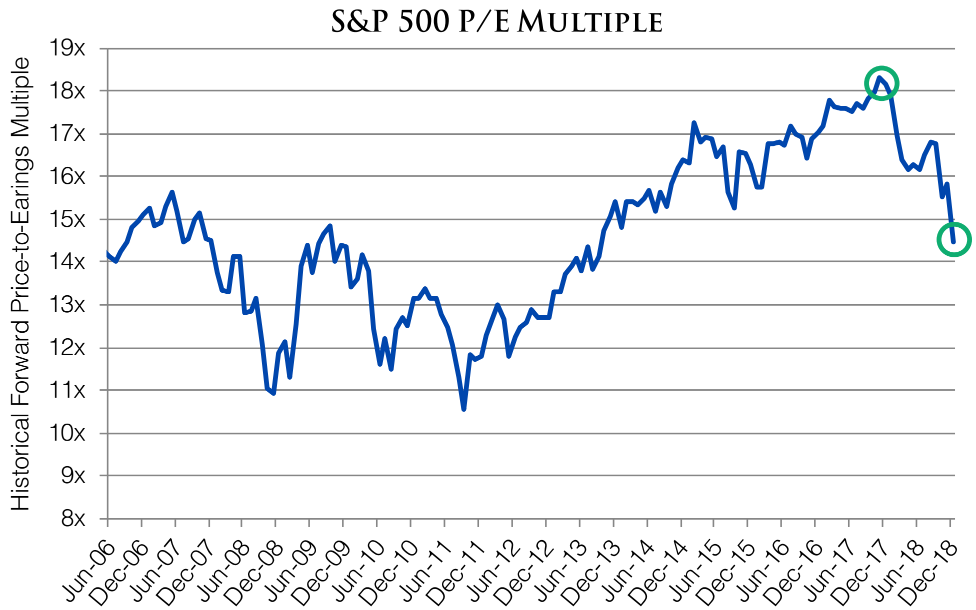
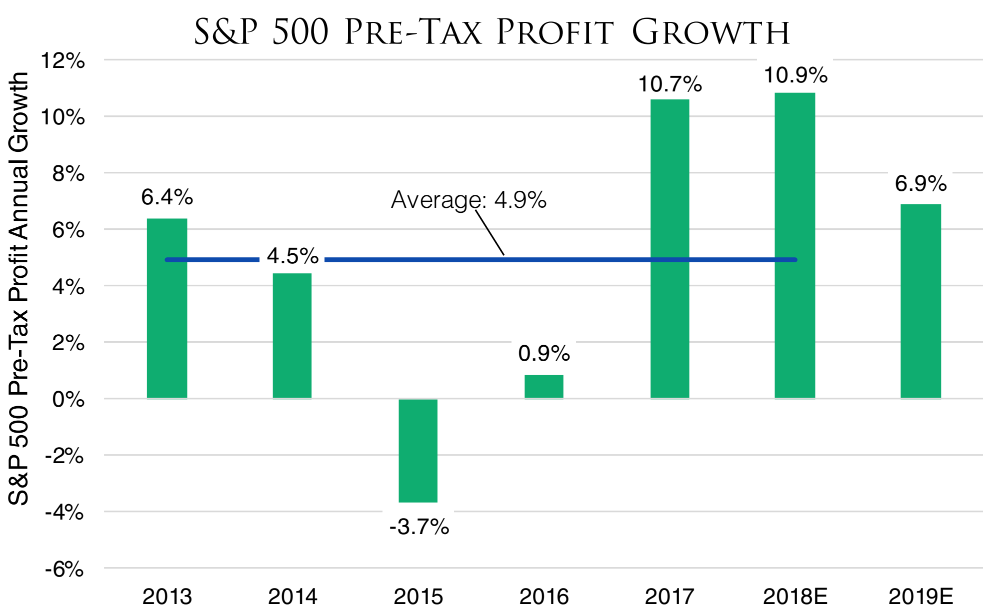
Greater Economic Challenges in 2019, but Equity Valuations are More Attractive



Source: Bloomberg, WestEnd Advisors



Source: Bloomberg, WestEnd Advisors

Portfolio Impact

We have a positive outlook for U.S. stocks in 2019. In particular, we see sectors like Information Technology and Communications as well positioned given their recent valuation declines and their exposure to both cyclical and secular drivers of earnings growth.

After the U.S. equity market pullback in Q4 and the S&P 500's 21% earnings growth in 2018, the 12-month forward P/E ratio for the S&P 500 Index fell to 14.5x as of December, its lowest level since 2013.

<u>Even though there may be more economic challenges in 2019, prospects for equity market returns may actually be improved in 2019</u> compared to 2018 given the reset in valuations for sectors like Information Technology and Communications.

If we exclude the boost from corporate tax cuts that benefitted 2018 growth, 2019 profit growth is expected to be slightly above the trend over the last five years (bottom chart).

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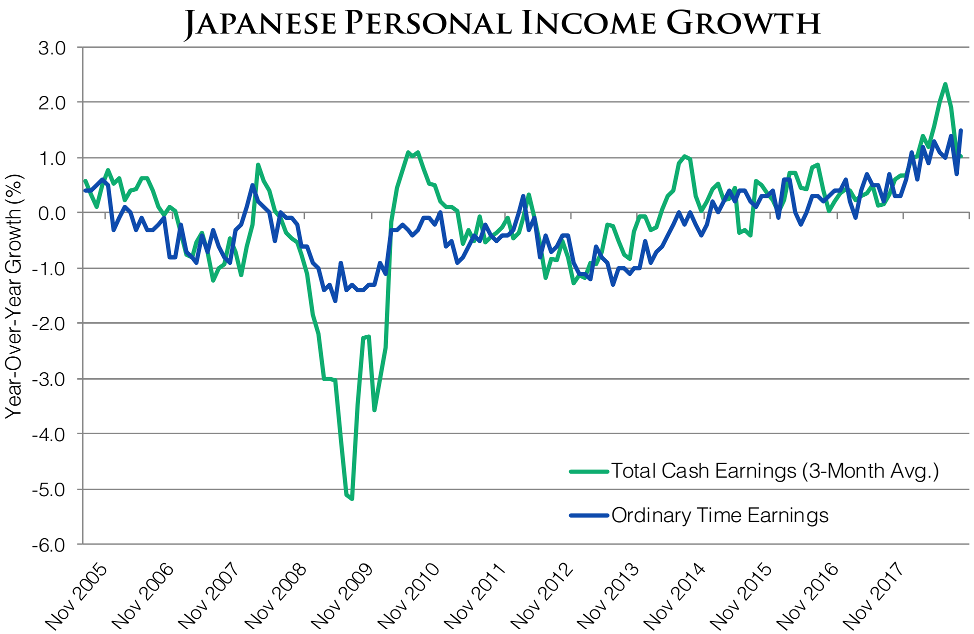
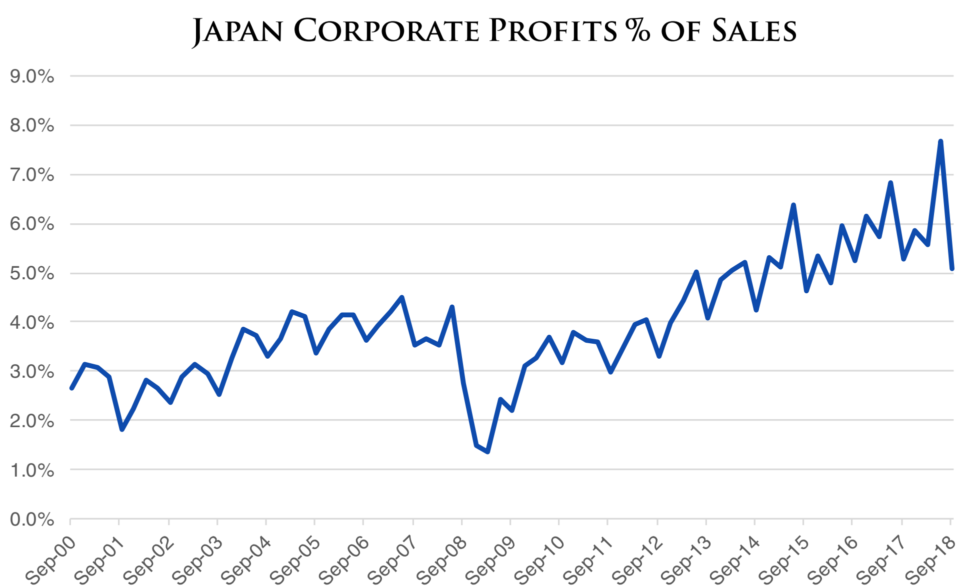
International Economic Backdrop

Japan on Track for Positive, Albeit Slow, Growth



Source: Ministry of Health, Labour, and Welfare Japan, WestEnd Advisors



Source: Ministry of Finance Japan, WestEnd Advisors

Portfolio Impact

Japanese equities, which are at a significant discount to U.S. stocks, now carry similar valuations to Europe. Unlike Europe, Japan's economic trends have shown signs of stabilization and there is potential for further improvement.

The negative factors within Japan's Q3 GDP reading look temporary as the economy is expected to move past natural disasters that weighed on growth.

Slow, positive economic growth should resume in Q4 and carry over to 2019. <u>Wage growth illustrates these positive trends and should support the consumer-based economy</u> (top chart).

Corporate profits also continue to improve and higher margins can offset cost pressures from a tight labor market.

Another sales tax hike looms in the fall of 2019, but economic impacts should be more mild than the last hike in 2014.

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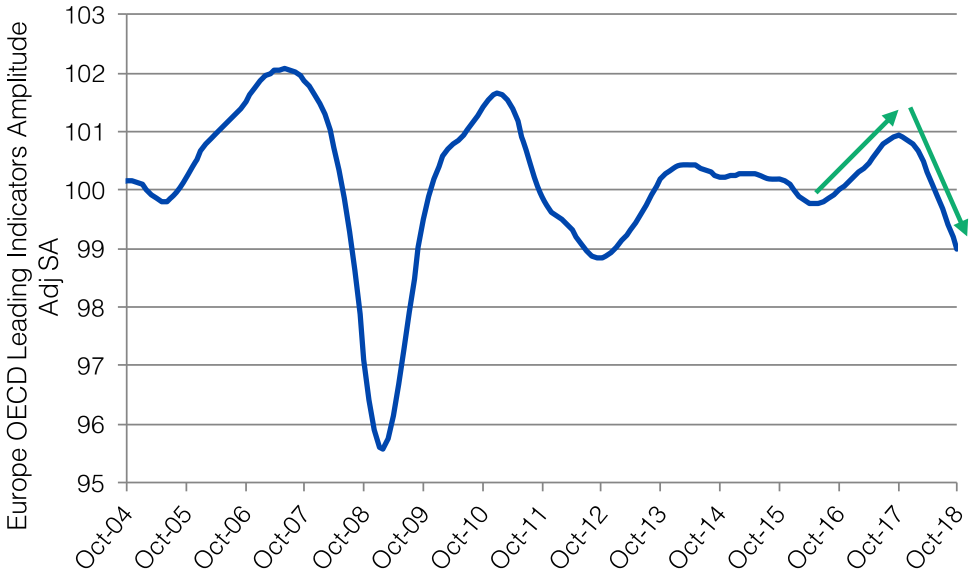
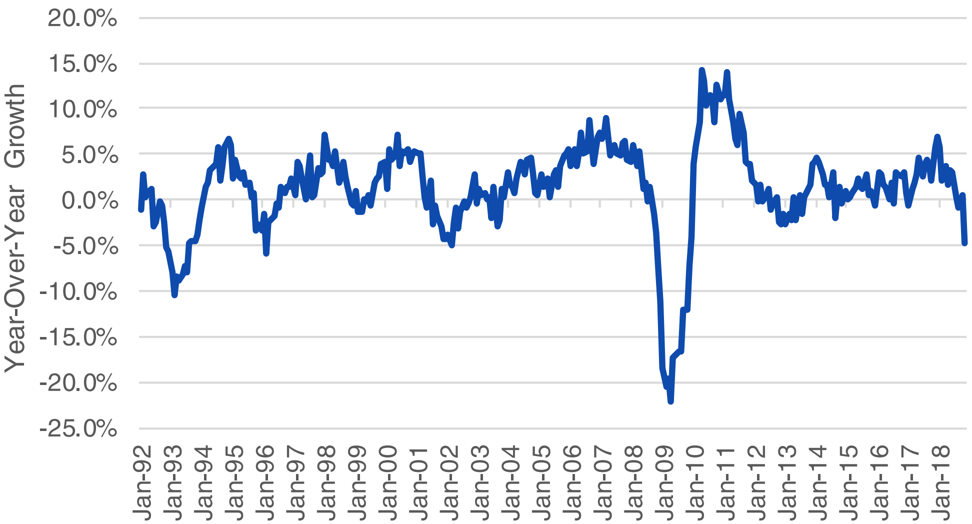
European Economic Picture Remains Challenged

OECD Leading Indicators - Europe



Source: OECD, WestEnd Advisors

Germany Industrial Production



Source: Deutsche Bundesbank, WestEnd Advisors

Portfolio Impact

An underweight of European equities is warranted. European valuations are lower than a year ago, but economic data exhibits a slowing growth trend. The risk/reward opportunity is unattractive heading into 2019 in our view.

Economic momentum in Europe has rolled over, with slowdowns coming from larger economies like Germany. We expect Euro Area GDP growth will be positive in 2019, but slower than U.S. growth. We also expect growth inconsistencies across the EA19.

Consumer spending can remain stable given healthy labor markets, but structural issues persist that will likely weigh on business sentiment and equity valuations. These issues include Brexit, Italy's debt negotiations, Germany's leadership uncertainty, and France's protests.

Monetary policy uncertainty also looms as ECB President Draghi steps down in Q4 2019.

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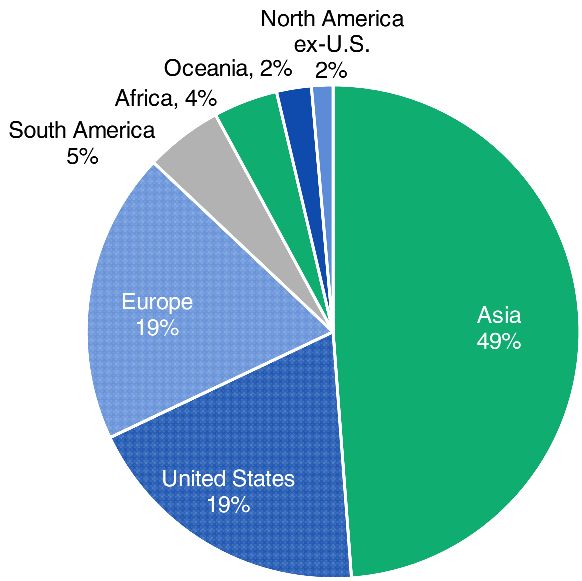
China Rides Out the Trade Storm

China Exports (in USD)



Source: Customs General Administration PRC, WestEnd Advisors

China Retail Sales of Goods

Source: National Bureau of Statistics, WestEnd Advisors

Portfolio Impact

We are also closely monitoring developments in Asia. An economic slowdown in China has occurred, but we expect growth stabilization in 2019 due to a combination of stimulus, trade clarity, and secular tailwinds for consumption.

China's trade relationship with the U.S. is being watched closely by us and other investors. Nevertheless, <u>for China, only 19% of exports go to the U.S.</u> This matches exports to Europe and is less than half of what is sent to other Asian countries, collectively. Consistent demand from non-U.S. trade partners can provide support to China's manufacturing output and export growth. A weaker RMB also presents support for Chinese exports.

Within China, the government's attempts to reign in excess credit growth has weighed marginally on consumption and business demand. Certain goods sectors, like auto sales, have suffered and weighed on aggregate consumption data (bottom chart). China is providing stimulus, such as cuts to auto sales taxes that should contribute to improved growth as 2019 progresses.

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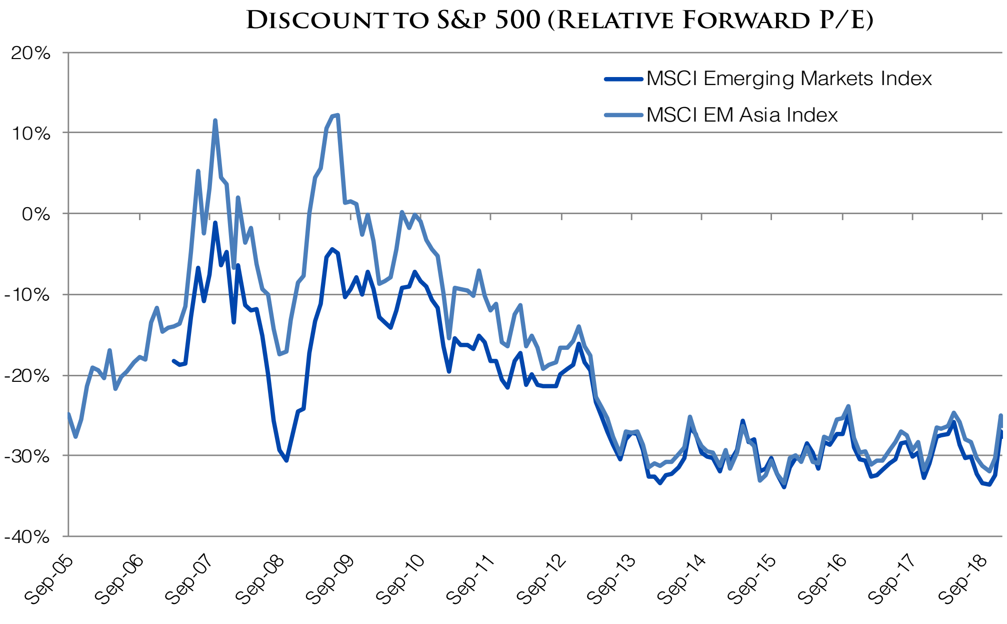
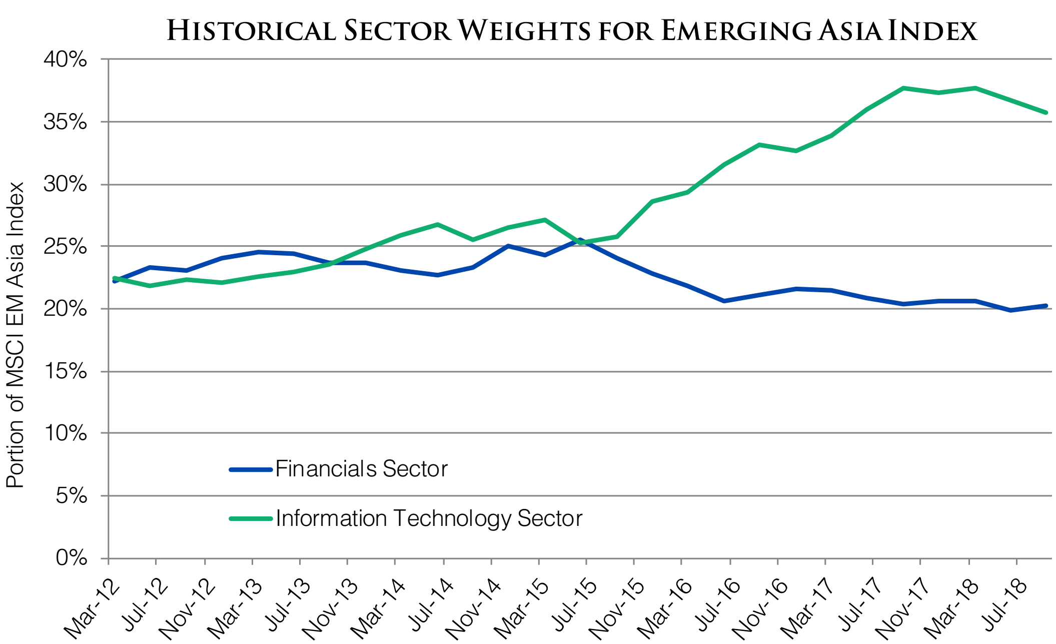
Emerging Asia Offers Secular Tailwinds and Attractive Valuations



Source: Bloomberg, WestEnd Advisors



Source: Bloomberg, WestEnd Advisors

Portfolio Impact

Chinese and other EM Asia equity valuations reflect overly pessimistic sentiment and risk aversion. We think stable-to-improving growth and contained trade war ramifications will push valuations higher and to more normal levels.

Emerging Asia forward earnings multiples are below their historical average and reached a ≈30% discount to the S&P 500 in Q3. EM Asia outperformed developed markets in Q4, supported by these historically low valuations.

Within EM, we favor Emerging Asian stocks in part because Asia is less commodity-oriented than areas such as Latin America. In fact, Technology companies have grown to over 35% of the MSCI Emerging Asia Index. Global tech leaders from Asia should continue to benefit from cyclical consumer and business spending, as well as from secular trends including accelerating internet penetration, rapid adoption of digital payments, and e-commerce growth. This exposure to secular growth drivers makes EM Asia stocks compelling at a price that is less than 11x forward EPS.

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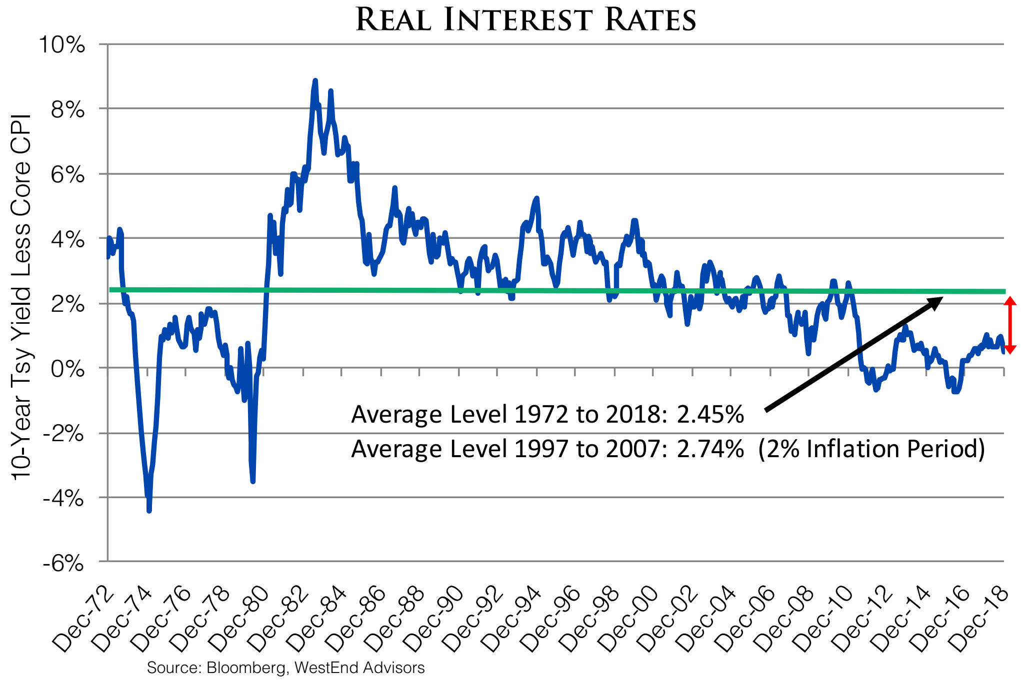
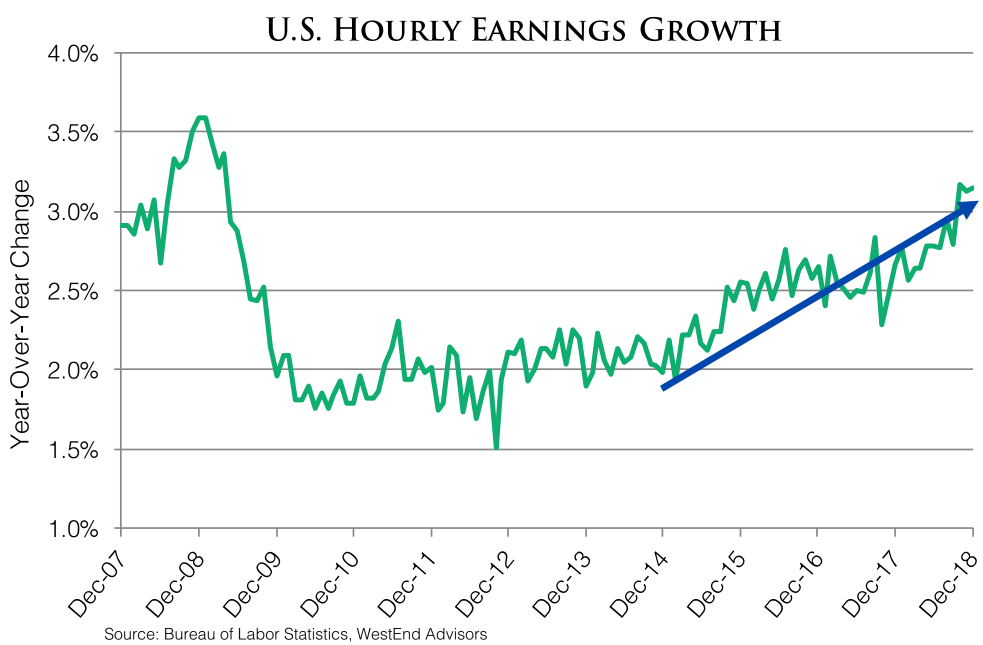
Inflation and Interest Rates

Interest Rates Fell in Q4 2018, But Upward Pressures Remain





Portfolio Impact

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

Equities: Continue avoiding sectors most negatively impacted by rising rates, like Utilities and Real Estate.

The yield on the 10-year Treasury bond declined 38 bps during the fourth quarter, but is still up 130 bps from the 2016 low.

A likely slower pace of interest rate hikes by the Fed along with worries about trade and growth contributed to the recent decline in interest rates.

Factors remain that are likely to push interest rates higher. Real interest rates remain low, for example. Inflation has moved above 2%, yet the 10-year Treasury yield's premium over inflation is well below the long-term average (top chart).

Another source of upward pressure on interest rates is the increase in hourly wages. The gains in wages amid subdued productivity gains is leading to cost pressures for businesses.

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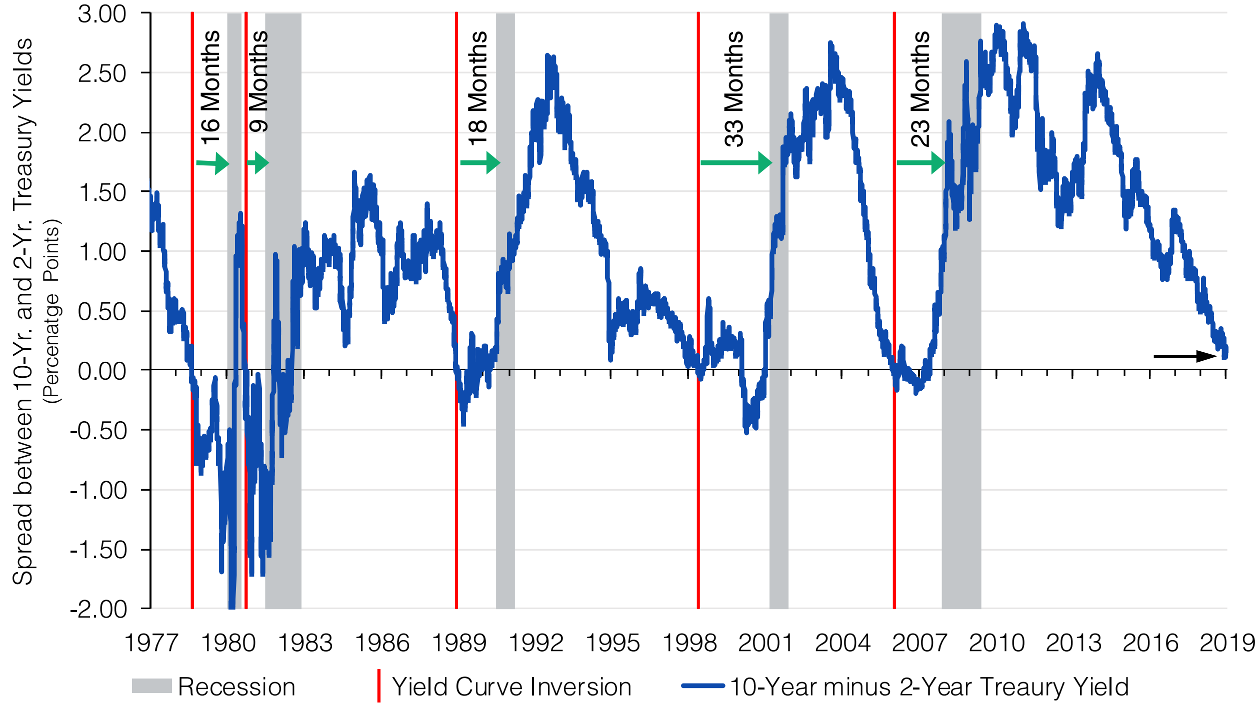
Yield Curve has Flattened, but Not Yet a Signal of Recession

Yield Curve and Recession Timing



Source: Bloomberg, WestEnd Advisors

We continue to monitor closely the spread between 2-year and 10-year Treasury bond yields. 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 also because inversion of the yield curve has historically been a leading, rather than a coincident indicator of recession.

<u>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.</u>

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.

Portfolio Impact

We expect the recent pullback in interest rates will reverse as investors' concerns over economic growth abate. Higher short-term interest rates and a more positive equity market outlook in general should benefit the Financials sector.

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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.

Any portfolio characteristics, including position sizes and sector allocations, among others, are generally averages and are for illustrative purposes only and do not reflect the investments of an actual portfolio unless otherwise noted. The investment guidelines of an actual portfolio may permit or restrict investments that are materially different in size, nature, and risk from those shown. The investment processes, research processes, or risk processes shown herein are for informational purposes to demonstrate an overview of the process. Such processes may differ by product, client mandate, or market conditions. 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.

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' strategies' 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.

The Bloomberg Barclays US Treasury Bill Index tracks the market for Treasury bills issued by the US government. The Bloomberg Barclays US Mortgage Backed Securities (MBS) Index tracks agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The Bloomberg Barclays US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. The Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. The Bloomberg Agriculture Spot Index measures the price movements of agricultural commodities included in the Bloomberg Commodity Index and select sub-indexes. The Bloomberg Precious Metals Spot Subindex measures the price movements of Precious Metals included in the Bloomberg Commodity Index and select sub-indexes. The Russell 2500 Index is composed of the smallest 2500 securities in the Russell 3000 Index. The Russell 2500 is constructed to provide a comprehensive and unbiased barometer for the small to mid-cap segment of the U.S. equity universe. The MSCI World ex-USA Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries excluding the United States. The MSCI EM (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across 24 Emerging Markets (EM) countries. The Bloomberg Energy Spot Subindex measures the price movements of Energy included in the Bloomberg Commodity Index and select sub-indexes. The Bloomberg Industrial Metals Spot Subindex measures the price movements of Industrial Metals included in the Bloomberg Commodity Index and select sub-indexes.