Late in the Game, but Not Down to the Buzzer

Strong equity returns in Q1 were largely a continuation of 2018's volatility, but moderate economic growth should also continue. We see sector selectivity as increasingly important given this late-cycle backdrop.

Summary

- Volatility continued in Q1, as global equity markets surged to recover most of the losses from Q4 2018, leaving them little changed from mid-2018 levels.
- Our outlook for moderate U.S. economic growth remains intact, while some late-cycle signs of slowing growth affirm our view that a sustained economic reacceleration is unlikely.
- U.S. interest rates continued to pull back in Q1, as the Fed signaled short-term rate hikes are on pause.
- Moderate growth and an advanced economic cycle warrant exposure to U.S. sectors with a mix of cyclical and secular drivers as well as sectors with limited economic sensitivity – sector selectivity will be increasingly important going forward.
- Our outlook for international equities is less positive, overall, given economic and geopolitical challenges, but we continue to view Asia as well positioned among overseas markets.

Q1 2019 Review

As moderate economic growth continued in the U.S., the S&P 500 posted a 13.65% return in Q1 2019, following a sharp decline in Q4. Information Technology led, along with other more economically-sensitive sectors like Real Estate, Industrials, and Consumer Discretionary. Less cyclical sectors, like Consumer Staples, Utilities, and Health Care, lagged. This relative sector performance was largely a reversal of Q4 amid ongoing market volatility. The fundamental backdrop was little changed, even as some economic data decelerated, in contrast to the out-performance of some more economically-sensitive areas of the market.

Modest Reduction of Economic Sensitivity:

March 2019 – We modestly reduced the economic sensitivity of portfolios' U.S. equity exposure, in part, by trimming Financials exposure and adding an allocation to the Utilities Sector.

International equities also rebounded sharply in Q1, led by emerging markets including China and Russia. As with the U.S., international market movements in Q1 primarily seemed to reflect a short-term shift in sentiment rather than a material change in fundamentals. In Europe, data in Q1 showed continued deterioration in some key measures, like German exports, while other data, like Euro Area retail sales, suggested stabilization. Still, Europe remained challenged by political and structural issues. In Asia, there continued to be some positive economic developments. For example, economic data released in Q1 showed Japanese Q4 economic growth rebounded from a negative reading in Q3 and emerging Asian economies appeared stable. Asian stocks, and particularly China, likely benefitted from renewed optimism for a near-term resolution of the U.S./China trade issues.

Outlook

The U.S. economy continues to deliver moderate economic growth. GDP in Q4 2018 (reported in Q1) grew at a 2.2% annualized rate, below that of Q2 and Q3 2018. For full year 2018, real GDP grew 2.9%, which was at the high end of the range in annual growth since the start of the economic recovery, as consumers exhibited some of this cycle's strongest spending.

The U.S. economy is on track to grow again in 2019, but the pace of growth will likely decelerate from what was achieved in 2018. Some consumer spending tailwinds are likely to diminish as we have passed the initial impacts of tax reform and stock market volatility has increased. Further, industrial production data has softened in early 2019, and higher interest rates since 2016 lows have pressured certain areas of the economy, including construction spending, where growth recently turned negative.

Volatility is likely to remain a key factor in equity markets this year. In a moderate economic growth environment, sentiment shifts can play an outsized role in short-term market movements. However, we believe markets, over time, will reflect underlying economic fundamentals as short-term volatility washes out. We still view the fundamental economic picture as positive, on balance, even as the risk of recession has gone up modestly.

We believe avoidance of the most economically-sensitive U.S. sectors is warranted, given the late-cycle economic backdrop. Our current U.S. equity exposure is focused on a mix of sectors with either (a) positive cyclical and secular drivers, like Information Technology and Communication Services, or (b) relative earnings stability, like Consumer Staples, Health Care, and Utilities. The Utilities Sector's highly consistent earnings and low correlation to the market can cushion portfolios amid volatile markets and a maturing economic cycle. While all sectors benefitted from the rebound in Q1, we view sector selectivity as crucial going forward and have positioned portfolios accordingly.

We remain underweight international equities in global portfolios. In Europe, attention began to focus on Germany's slow growth in late 2018. While temporary events, such as regulatory disruption to the auto industry, are partly to blame, overall growth in Europe remains low, and structural issues ranging from Brexit to restrictive labor laws present continued headwinds. We are less underweight to Asia, where more stable growth and low relative valuations present a more attractive risk/return profile.

In balanced portfolios, we continue to emphasize shorter-duration fixed-income securities. While the risk of rising rates has eased somewhat, the cost of avoiding that risk is low given the flattened yield curve.

WestEnd Advisors Investment Team | April 1, 2019

This report should not be relied upon as investment advice or recommendations, and is not intended to predict the performance of any investment. These opinions may change at anytime without prior notice. All investments carry a certain degree of risk including the possible loss of principal, and an investment should be made with an understanding of the risks involved with owning a particular security or asset class. Portfolio characteristics and/or allocations are generally averages and are for illustrative purposes only and do not reflect the investments of an actual portfolio unless otherwise noted. 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. While every effort has been made to verify the information contained herein, we make no representation as to its accuracy.

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.

DISCLOSURE UPDATE: On December 31, 2021, Victory Capital Holdings, Inc. ("Victory Capital") acquired WestEnd Advisors, LLC ("WestEnd"). WestEnd, an SEC-registered investment adviser, operates as an autonomous Victory Capital Investment Franchise. WestEnd's active principals continue to be responsible for managing the firm and its day-to-day operations.