WestEnd
ADVISORS

Q3 2019

WestEnd Advisors

Macroeconomic Highlights

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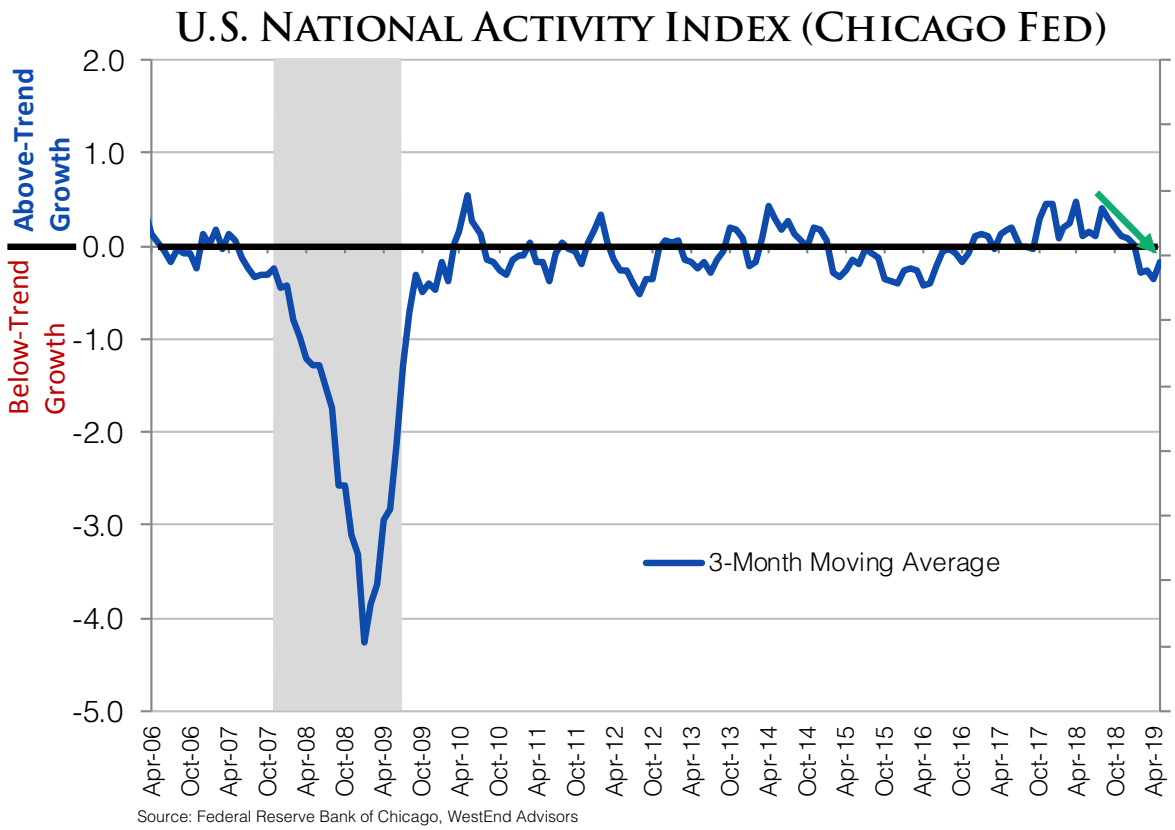
WestEnd Outlook Highlights

- The U.S. economic expansion continues. Despite slowing growth and early signs of actual flow-through of international trade tensions in economic data, we still view moderate growth as likely to persist in the near-term.
- The current, partially-inverted shape of the yield curve is unsustainable, and some reduction in short-term rates seems the most likely path toward rate normalization.
- International economic growth continues to struggle against headwinds from structural challenges, cyclical patterns, and, increasingly, headwinds to global trade.
- With increased likelihood of Fed rate cuts, we have de-emphasized shorter-duration fixed-income securities.

U.S. Economic & Market Backdrop

U.S. Economic Activity Decelerates to Start 2019



Portfolio Impact

Moderate growth and an advanced economic cycle warrant exposure to a mix of sectors:

Technology & Communication Services:

Sectors that benefit from sustained cyclical and secular growth drivers.

Consumer Staples, Health Care & Utilities:

Sectors that deliver steady earnings growth and can benefit from secular growth drivers.

Core components of GDP like consumer spending and private investment slowed in the first half of 2019 as the 3.1% GDP growth in Q1 was supported by more volatile components of GDP like Net Exports and Inventories.

Another measure of broad U.S. economic activity, the Chicago Fed National Activity Index (CFNAI), also points to a deceleration in growth thus far in 2019. **Recent CFNAI readings indicate that the U.S. economy is growing at a below-trend pace,** but at the same time we have seen similar periods of subdued growth during this near-decade-long, moderate-growth expansion.

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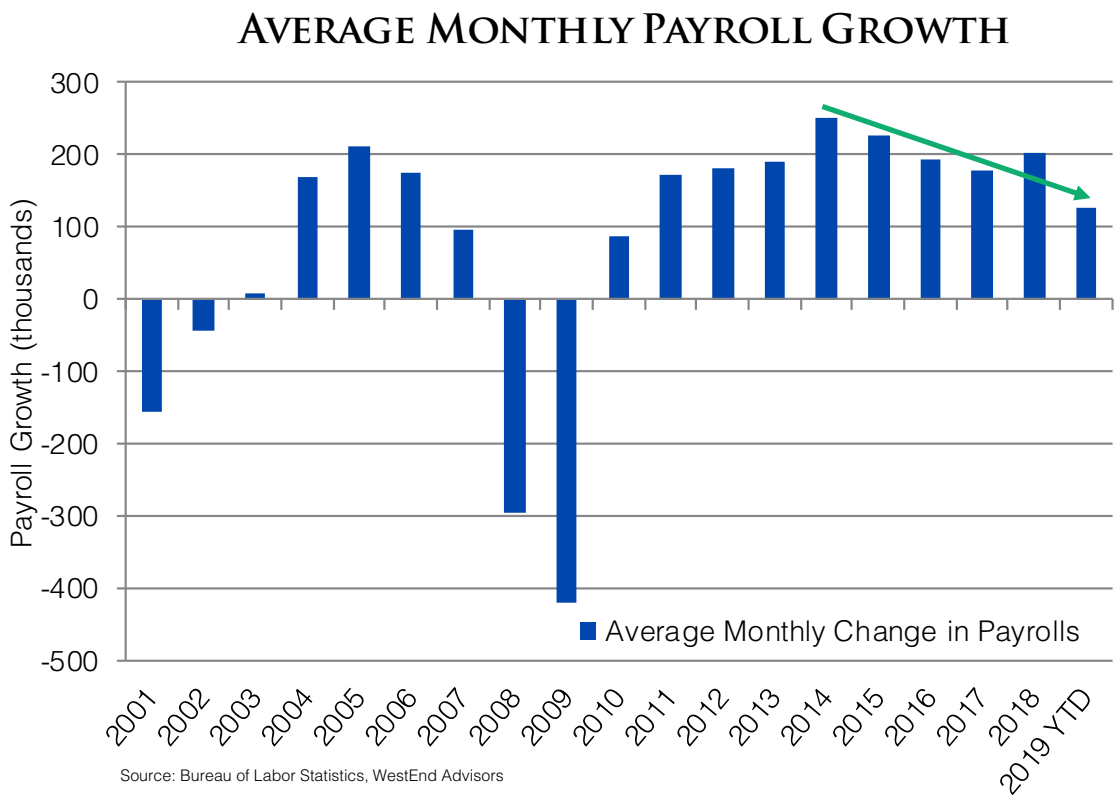
U.S. Economic Cycle Continues to Mature



Portfolio Impact

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

Energy and Industrials Sectors:

In equity allocations, avoid more economically-sensitive sectors that typically benefit from dynamic economic growth.

A variety of readings across the U.S. economy, including auto sales, construction spending, and the unemployment rate, point to the significant progress that has been made in the current economic expansion. The chart above focuses on payroll growth, another **labor market indicator that points to the maturing of the economic cycle.** The chart illustrates that the pace of payroll gains has diminished in recent years (2018 being the exception), consistent with the trend in prior cycles as those cycles have progressed.

The recent slower economic activity, together with the advanced stage of the economic cycle, bears close watching, but **our base case remains moderate economic growth for the U.S. economy**.

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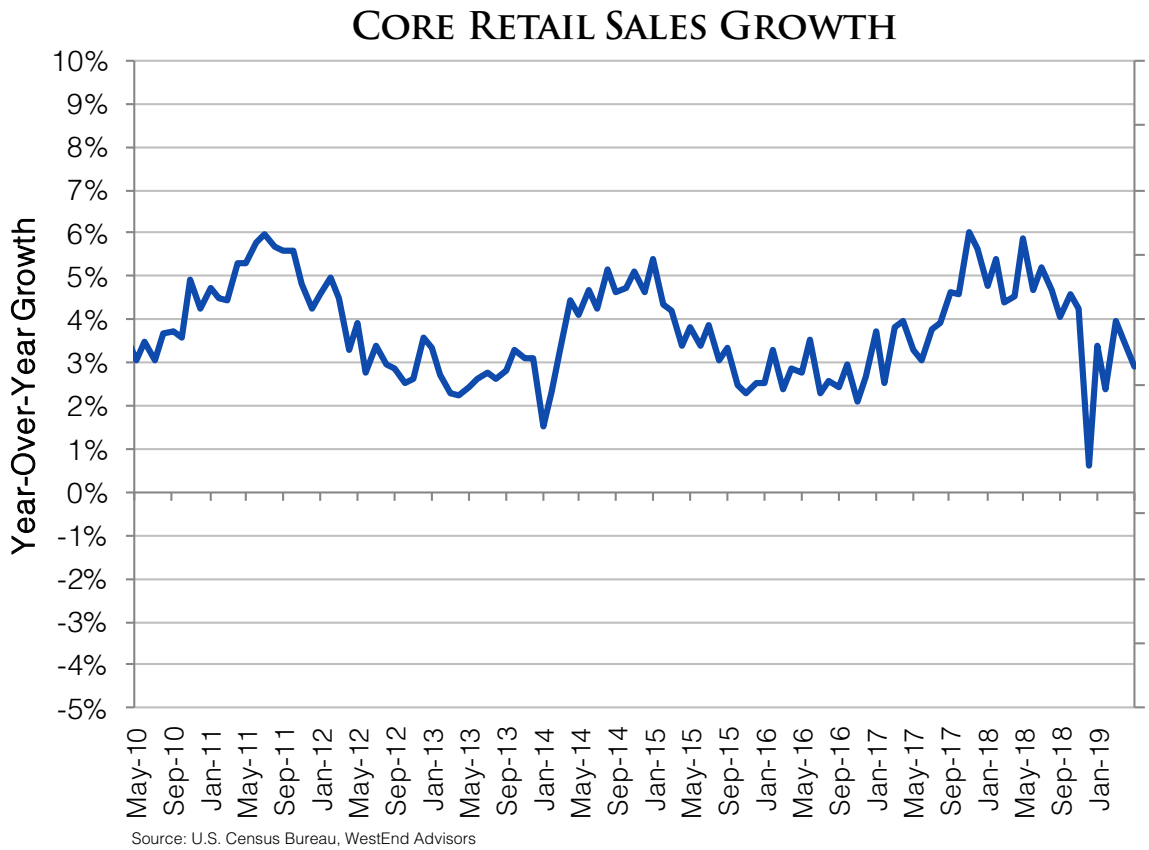
U.S. Consumer Spending Provides Stability



Portfolio Impact

Consumers remain an important aspect of U.S. economic growth, and consumer spending continues to grow, despite some recent deceleration, supported by record-low layoffs and solid personal income growth.

Recent data indicates that the production portion of the U.S. economy has softened in 2019. Growth in Manufacturing Production, for example, has declined 1% for six months ended May. Growth in consumer spending has also weakened, but the slowdown has not been as severe.

Core Retail Sales have grown 3% year-over-year as of May. The current pace of growth is down from what was essentially a cycle high in 2018, but it is still healthy. Annual Personal Income gains of 4.1% are supporting the gains in consumer spending. These gains in consumer spending are important for consumer businesses and provide stability for the U.S. economy as a whole.

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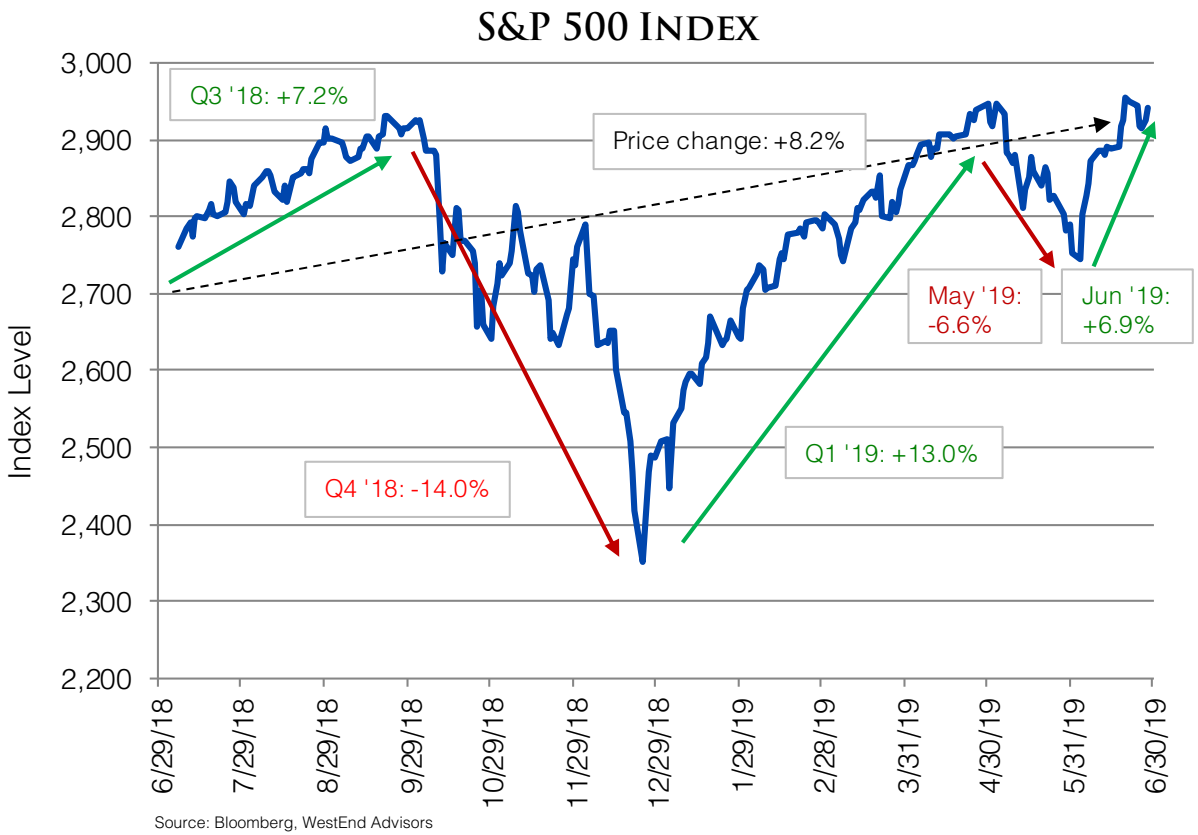
Big Equity Market Swings, but Muted Return



Source: Bloomberg, WestEnd Advisors

Portfolio Impact

Economic growth in the U.S. has been relatively steady even as the stock market has delivered some significant positive and negative moves over the last year.

We have seen a series of significant swings in the stock market since the start of Q3 2018:

- Q3 2018 and Q1 2019 were the top two quarterly returns for the S&P 500 since 2013.
- Q4 2018, sandwiched between those two quarters, was the worst quarter since 2011.
- Q2 2019 had significant volatility *within* the quarter. The S&P 500 Index fell over 6% in May and then rebounded nearly 7% in June.

Despite all the sizable moves, the S&P 500 Index value was only up 8.2% over the 12 months ended June 2019. **This type of volatility is not unusual as a market cycle advances**.

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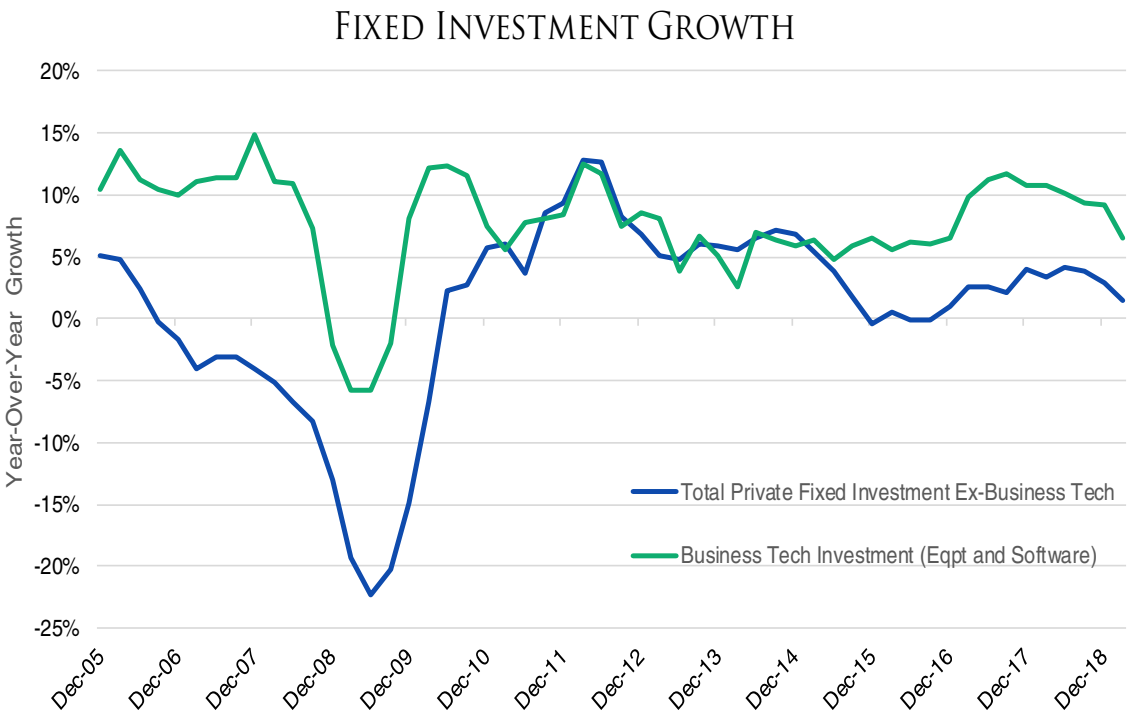
U.S. Sector Outlook

Business CapEx Drives Technology Sector Growth



Source: Bureau of Economic Analysis, WestEnd Advisors

Portfolio Impact

Technological innovation and corporations' pursuit of productivity gains drive higher Tech CapEx. Technology companies should benefit from these trends during this stage of the cycle.

Fixed Investment continues to contribute to U.S. real GDP growth, led by Fixed Investment in technology-related goods and services, which is outpacing investment in structures and other equipment.

We believe that the fundamental drivers of **increased tech spending can persist at this stage of the cycle** for a couple of reasons:

- A wave of technological innovations such as cloud computing, cybersecurity, and software-defined networking has created opportunities and complexities that enterprises and small businesses need to address.
- At this stage of the cycle, labor costs are rising, and investment in technology can enhance productivity.

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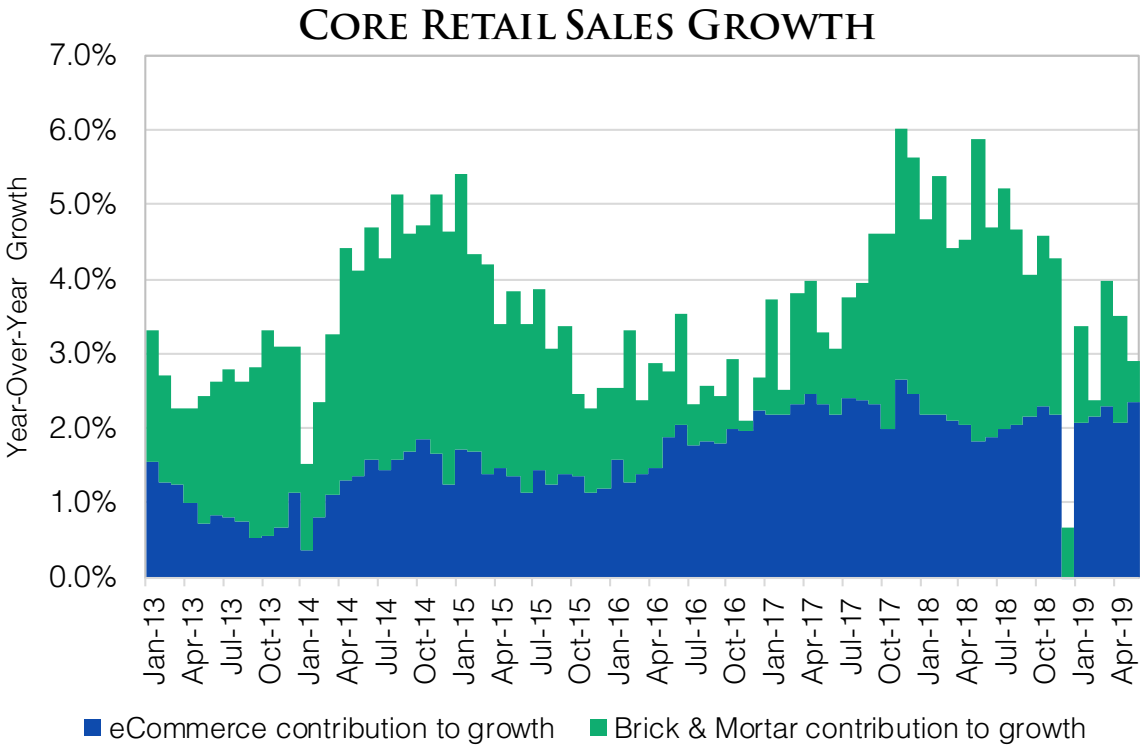
Retail Sales Growth Skewed to eCommerce Again



Source: U.S. Census Bureau, WestEnd Advisors

Portfolio Impact

Growth in online consumer spending is currently a key driver of overall retail sales growth. Investors can gain exposure to this trend through eCommerce focused businesses as well as retailers that are successfully executing on omni-channel strategies (both digital and brick & mortar platforms).

In 2018, a broad set of retail sales categories, including traditional brick & mortar focused categories, contributed to the elevated pace of growth. To start 2019, however, eCommerce has reemerged as the predominant driver of Core Retail Sales growth.

In fact, as the chart above highlights, **the eCommerce category has accounted for about two-thirds of the 3.2% annual growth through the first five months of the year**. Sales growth for Nonstore Retailers (i.e. eCommerce) has remained above 10% year-over-year in 2019, even as growth has decelerated in categories like Home Furnishings and Department Stores.

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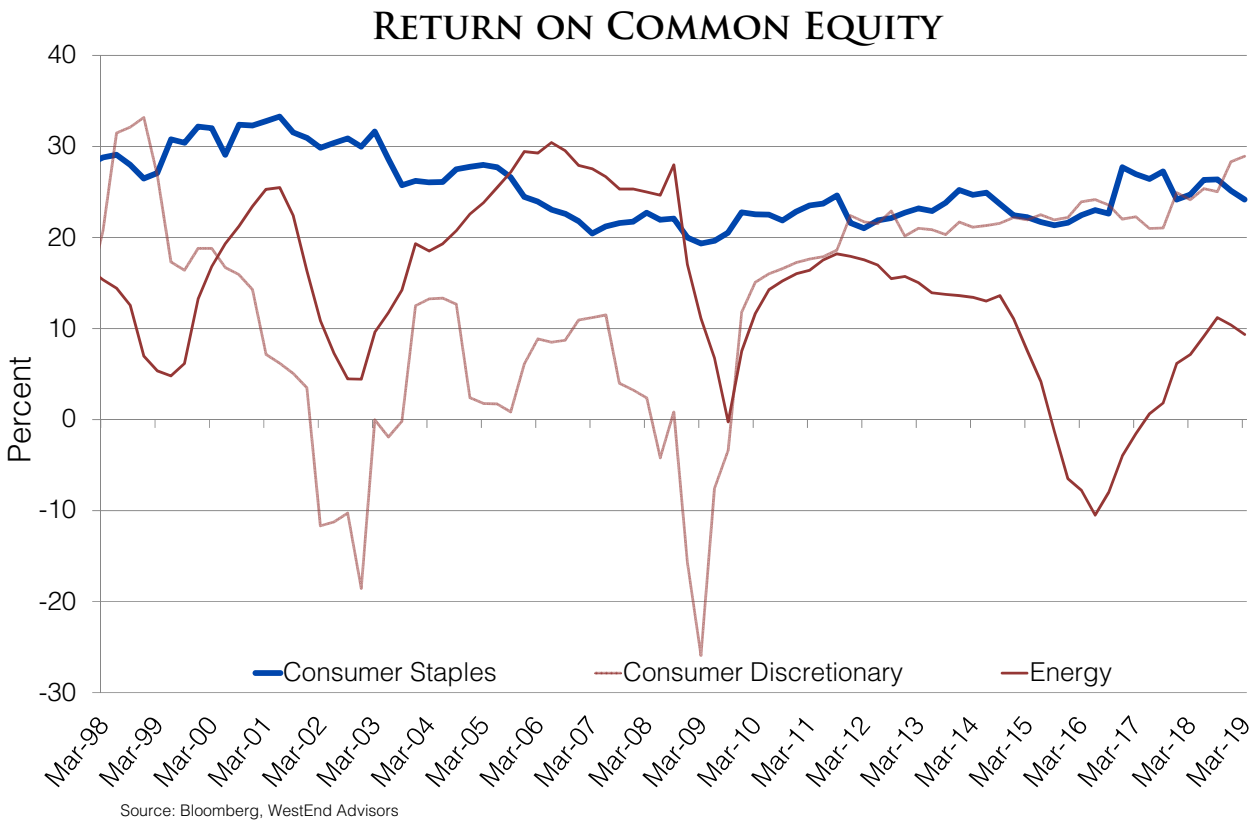
Staples Sector Companies Provide Steady Earnings



Source: Bloomberg, WestEnd Advisors

Portfolio Impact

We believe continued exposure to the consumer – a key driver of economic growth – is warranted.

Consistent and above-market ROEs make Consumer Staples more attractive than Consumer Discretionary at this stage of the cycle.

We see the financial stability of Consumer Staples companies as desirable, particularly as the economic cycle matures and the risk of a substantial move higher in interest rates has diminished.

Consumer Staples companies have generated above-market return on equity (ROE) over time. More importantly, **Consumer Staples' ROEs are very consistent**. Alternatively, economically sensitive sectors like Energy and Consumer Discretionary have much more cyclical ROEs, as illustrated in the chart above.

ROE for Consumer Staples has been 20% or better for the last 20 years, while ROE for the Energy and Consumer Discretionary Sectors has dropped to near zero or worse on several occasions.

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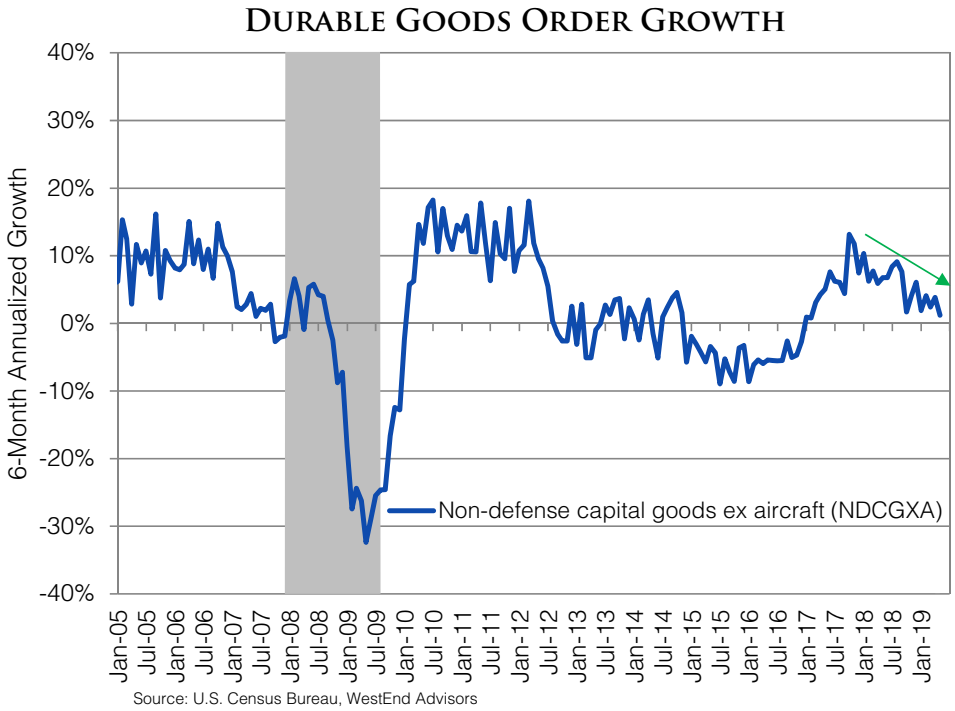
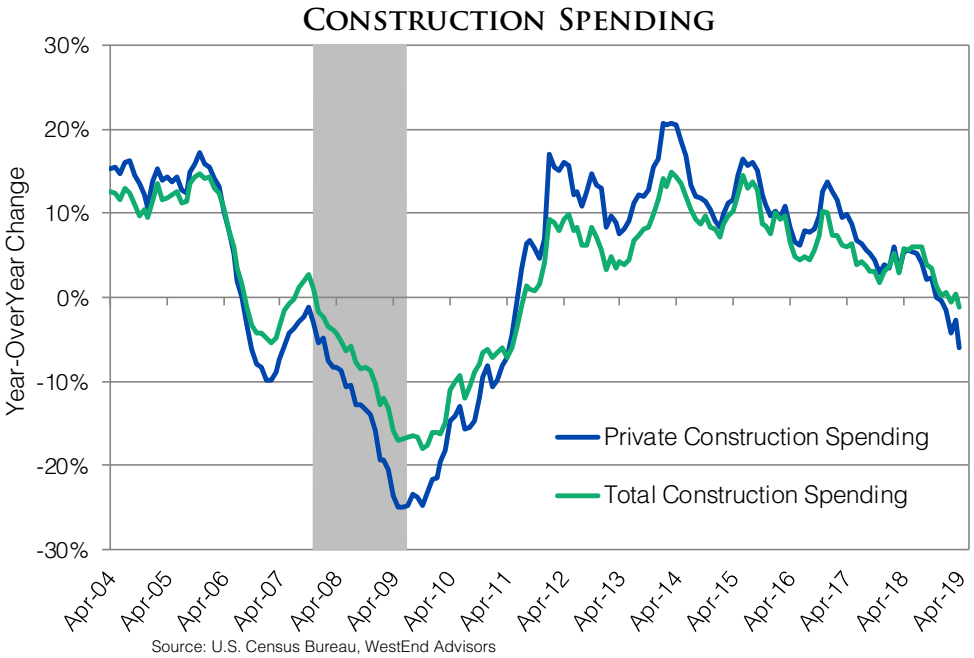
Industrials Sector Faces Headwinds





Portfolio Impact

Progress in the U.S. economic cycle along with an outlook for unexciting global growth warrants avoiding U.S. Industrials Sector stocks.

The economy has made significant progress since the cyclical trough in 2009. Business CapEx orders and construction spending have improved significantly from their lows.

Business CapEx (measured by NDCGXA orders) saw improved growth in 2017 and 2018. In recent quarters, however, **the pace of investment has slowed, particularly on industrial equipment**.

Private construction, which is typically more cyclical than public construction, has also weakened. **Private construction growth has turned negative for the first time since 2011** as Single-Family construction and Home Improvement spending have fallen 7.6% and 21.7%, respectively, over the last twelve months.

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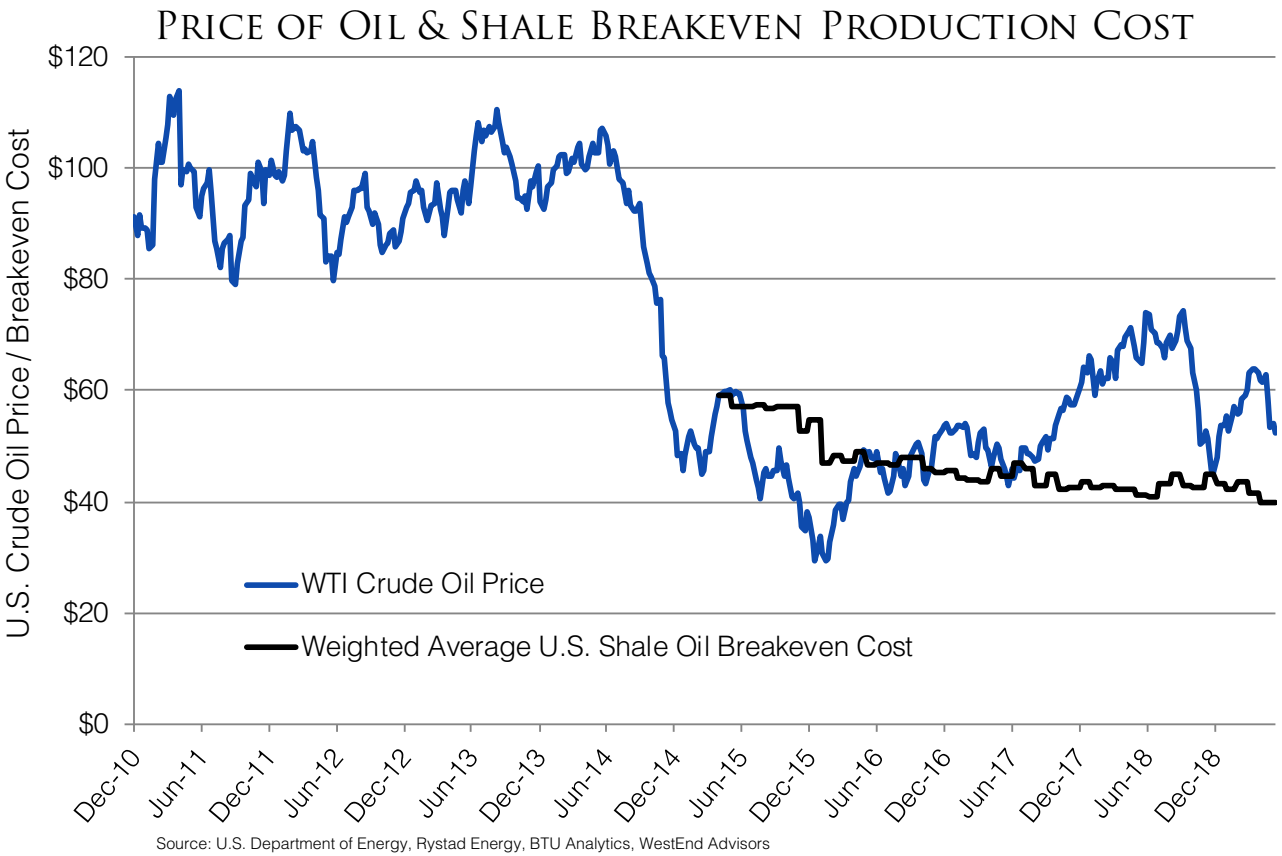
Energy Sector Challenges Likely to Persist



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 remain volatile in 2019, including Q2. Oil prices fell overall in Q2 after they had rebounded to start the year. Even after the recent decline, the price for a barrel of West Texas Intermediate (WTI) crude oil remains significantly above the breakeven cost for U.S. shale producers.

With the price of WTI well above the cost of shale production, we expect producers to maintain, or even increase the amount of oil they bring to market. Elevated supply of oil, together with sluggish global economic growth, indicates **the price of oil is likely to remain under pressure, and Energy Sector earnings are likely to be challenged**.

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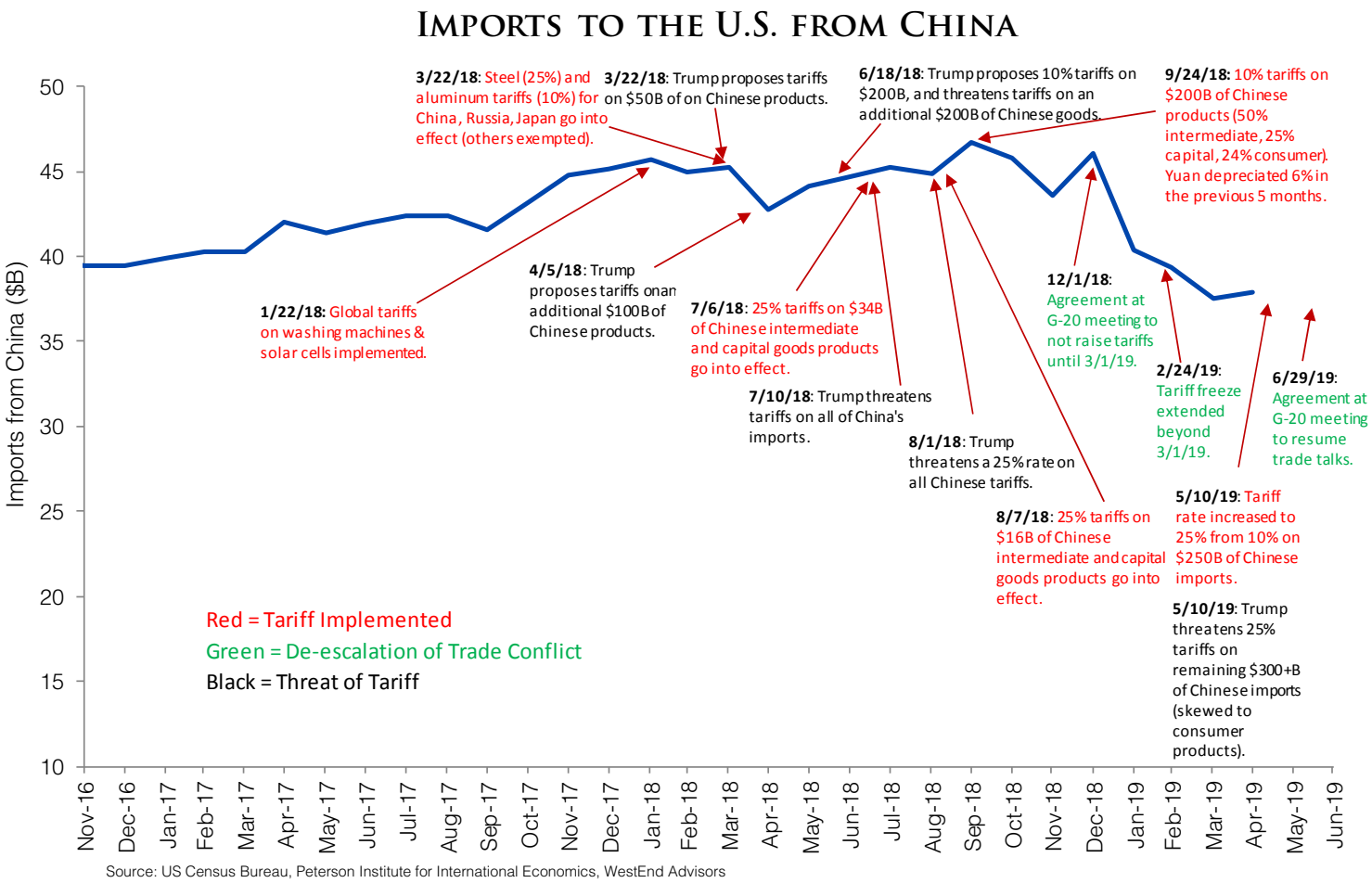
International Economic & Market Backdrop

Tariffs have Weighed on Global Trade



Source: US Census Bureau, Peterson Institute for International Economics, WestEnd Advisors

Portfolio Impact

Tariffs have had an impact on the economic backdrop, but there has been fundamental softness that goes beyond the trade developments and is consistent with soft global growth.

The Trump Administration ratcheted up the tariff threats on Chinese products in the first half of 2018, but it was not until 10% tariffs were implemented on $200 billion of Chinese goods in September 2018 that U.S. imports from China were negatively impacted. As of April 2019, imports from China were 19% below the September 2018 level. This decline, however, does not incorporate the tariff rate increase to 25% from 10% that was implemented in May 2019 on $250 billion of goods.

It is worth noting that to date U.S. tariffs on Chinese goods have focused on intermediate and capital goods, rather than consumer goods. **The trade dispute has hurt certain segments of the global economy like Chinese production and U.S. agriculture, but the overall impact has been contained.**

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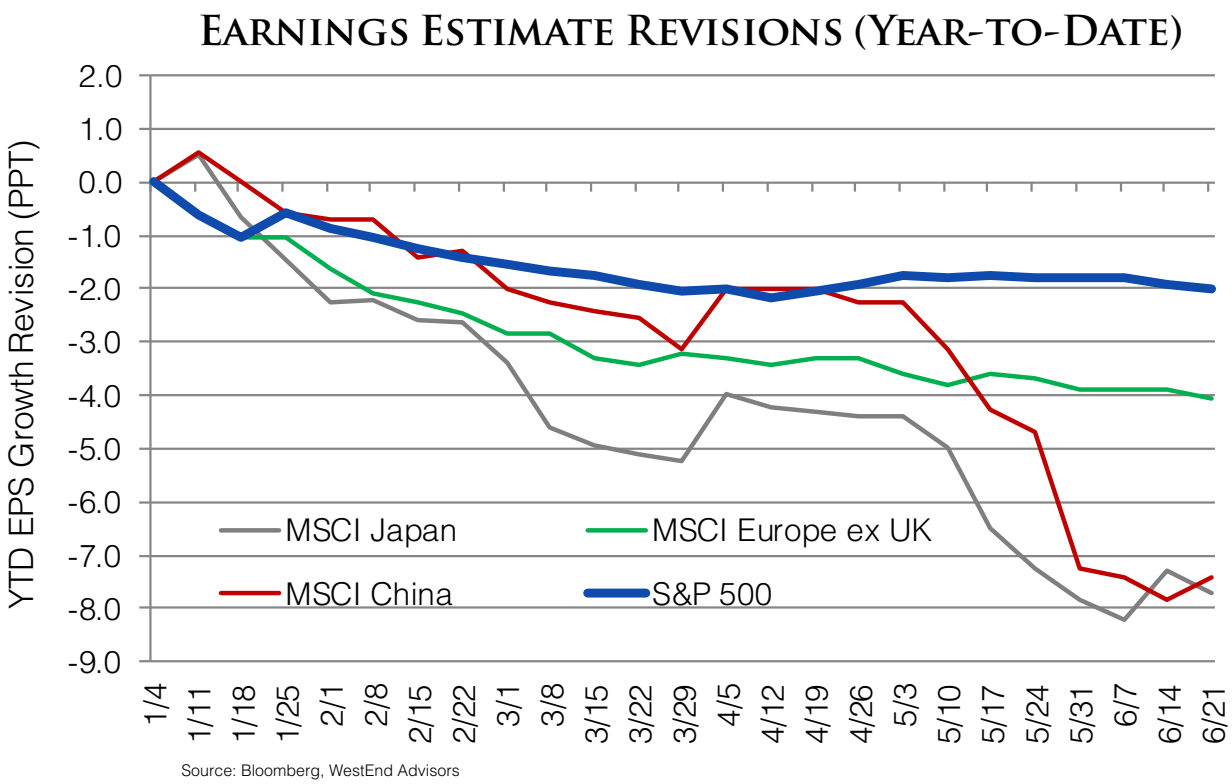
Earnings Revisions Favor the U.S. Year-to-Date



Portfolio Impact

We see the equity market opportunities in favored U.S. sectors as more compelling than the opportunities in regions overseas. The stronger fundamentals in the U.S. continue to justify the valuation premium for U.S. equities compared to foreign equities.

Economic growth in the U.S. has slowed compared to 2018, but the U.S. economy continues to look favorable compared to conditions in Europe and Japan.

- European growth has suffered this year as the German economy has weakened due to softer manufacturing production.
- The Japanese consumer is healthy, but manufacturing activity has suffered with weaker Asian growth.

Expectations for earnings growth have come down globally, but **the U.S. has seen the smallest downward revisions to earnings among the major economic regions**.

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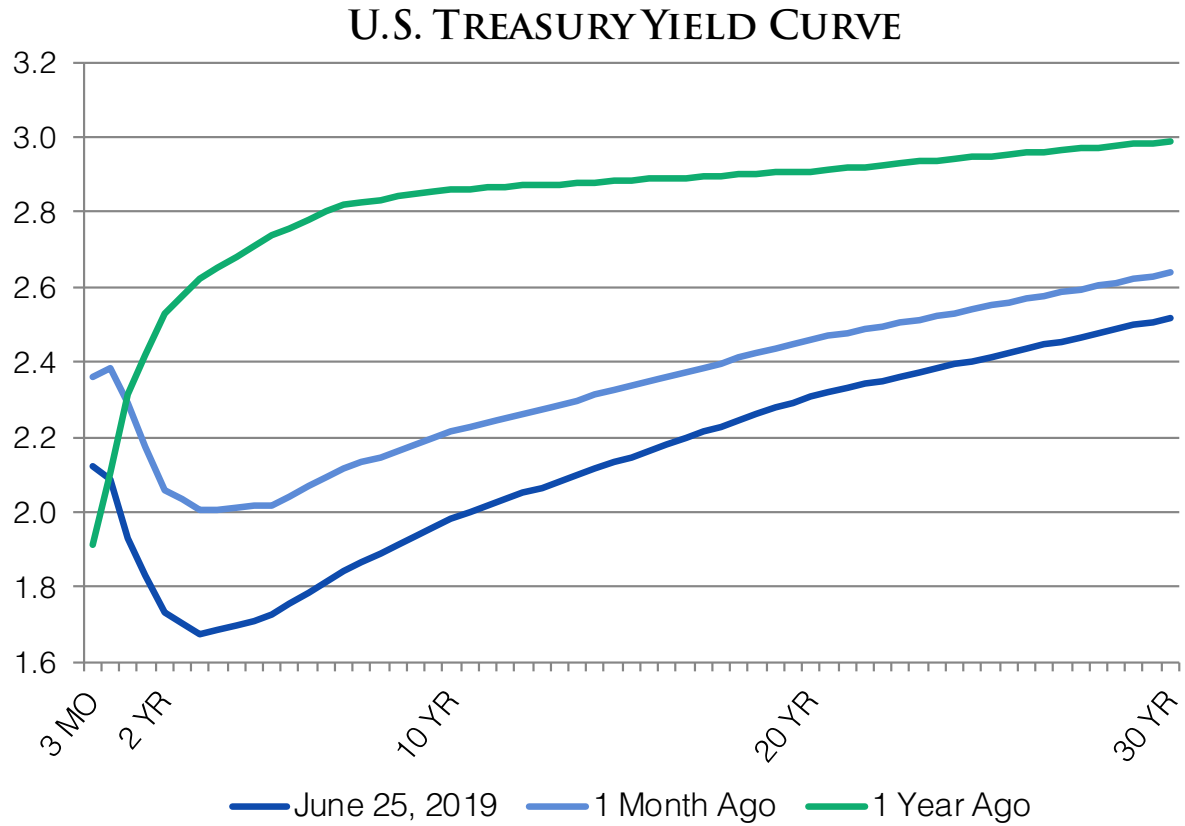
Interest Rates

Current Shape of the Yield Curve is Unsustainable



Source: Bloomberg, WestEnd Advisors

Portfolio Impact

We believe the probability of a Fed Funds rate cut has increased. Given this outlook, we believe it is warranted to replace allocations to floating-rate corporate bonds, which have very short durations, with allocations to intermediate-term corporate bonds and longer-term Treasury securities.

Recent economic data suggests moderate economic growth is decelerating somewhat and inflation remains persistently below the Fed's 2% target (even when excluding recent temporary factors). As a result, upward pressures on interest rates have eased.

These and other factors have reshaped the U.S. Treasury yield curve, which has flattened significantly and inverted for certain parts of the curve. The current shape of the yield curve is a new development during this economic expansion and, in our view, unsustainable. This leads us to believe that either short-term rates will come down (e.g. the Fed may cut its overnight Fed Funds rate), or longer-term rates will rise. **We see Fed Funds cuts as more likely in the intermediate term**.

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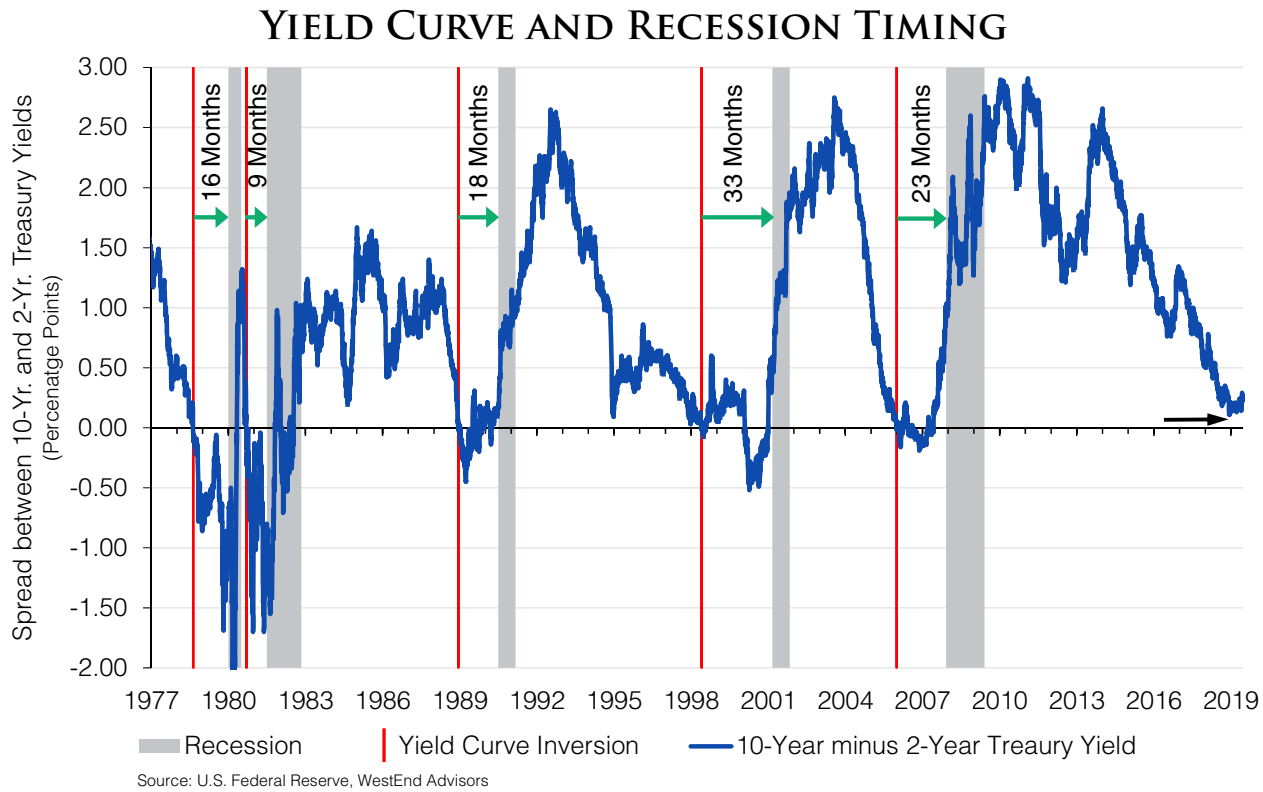
Yield Curve Inversions are Important, but Recession Timing Varies



We continue to monitor closely the spread between short-term and long-term Treasury bond yields. We believe inversion of the yield curve can be a useful signal in interpreting the future strength of the economy.

At the same time, over the past five economic cycles, there has been an average of over 20 months from the time the 2-year yield to 10-year yield first inverts to the start of a recession.

In our view, **the current yield curve, though much flatter than a few years ago, is more indicative of a late-cycle expansion with room for growth than of an impending recession or extended bear market**.

Portfolio Impact

Recent slower economic growth, along with inversions of portions of the yield curve, warrants close attention, but our base case remains for the U.S. economy to grow at a moderate pace.

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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.

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.