2019 – Market Growth Spurt in a Maturing Economic Cycle

The economic cycle continued to mature in 2019, as U.S. consumption and manufacturing diverged. Headwinds from trade slowed growth abroad, but rising valuations powered strong market returns globally.

As we approach the end of 2019, we would like to highlight what we view as some of the key economic and market developments of 2019 and, where relevant, how these developments impacted our portfolio allocation decisions (see call-out boxes). We will publish our standard 2020 outlook as part of our regular Q4 2019 commentary in early January.

U.S. Economic Drivers Diverged

The U.S. economic cycle continued to mature in 2019. Positive-but-decelerating growth reflected consumer strength partly offset by weakness on the production side of the economy. A strong labor market supported personal consumption in 2019, with the unemployment rate at a fifty-year low of 3.5% in November, and hourly wage growth of more than 3% year-over-year in 2019.

Manufacturing and production-related industries, however, decelerated or even declined in 2019. Industrial production growth turned negative year-over-year, private construction spending growth has been negative since late 2018, and growth in industrial equipment investment has dropped by half since Q4 2018. With conflicting consumer and production trends, overall U.S. economic growth slowed in 2019. Despite annualized growth of 3.1% in Q1, real GDP growth for the first three quarters of 2019 averaged just 2.4%, and Q4 GDP is widely expected to be 2% or less.

Reducing Portfolios' Economic Sensitivity:

March/June 2019 – Reduced, then eliminated exposure to the economically-sensitive U.S. Financials sector in expectation of lower short-term rates; added new U.S. Utilities exposure; and increased allocations to U.S. Info. Tech. and Comm. Services, sectors with secular tailwinds.

Rising Valuations Drove Strong Equity Returns

Global equity returns year-to-date in 2019 exceeded our relatively optimistic expectations. Through December 16, the MSCI ACWI returned 25.1%, as forward P/E valuations expanded materially. Most international regions produced strong double-digit equity returns, but generally underperformed the U.S. as economic growth abroad faced stronger headwinds from structural and geopolitical issues.

At the start of 2019, we noted that equity valuations had become "very attractive," given the significant earnings growth and year-end market pullback of 2018, and given our expectation for continued moderate economic growth. As of December 31, 2018, the 12-month forward P/E ratio of the S&P 500 had fallen to about 14.5x, in line with 2013 levels. This represented a reduction of risk in equity markets and, in our view, created attractive opportunities in sectors that are not reliant on dynamic, early-cycle economic growth. We expected, however, that earnings growth would be a key driver of returns this year rather than valuation expansion. In fact, full-year earnings per share for the S&P 500 are now expected to decline modestly, and differences in earnings growth among sectors have been largely overshadowed by broad-based P/E multiple expansion. The forward P/E on the S&P 500 has risen to about 18x, driven in part by falling interest rates. Information Technology has been the best-performing U.S. sector YTD, and secular trends remain favorable for the sector. Energy has been the worst-performer as economic growth slowed. Health Care also underperformed in 2019, likely reflecting elevated political rhetoric over health care costs and the sector's relatively defensive characteristics.

Interest Rates Fell

The U.S. interest rate environment evolved significantly in 2019. After the Treasury yield curve flattened and economic growth slowed in 2018, we had anticipated the Fed would slow or halt its rate hikes in 2019. However, by the end of July, the 10-year Treasury yield had fallen more than half a percentage point, and the Federal Reserve began cutting the Fed Funds rate. While the spread between 2 and 10-year Treasury yields briefly inverted in August, two more rate cuts helped normalize the slope of the yield curve as short-term Treasury rates followed the Fed Funds rate down. Still, the curve remains relatively flat by historical standards. Corporate investment-grade bond yields also declined, and their spreads versus Treasury bonds narrowed as economic growth continued.

Adapting to a New Rate Environment:

June 2019 – Extended the average duration of fixed-income allocations from short to intermediate-term as the probability of Fed rate cuts increased.

Geopolitical Risks Had Mixed Impact

Many of the political and geopolitical issues that dominated news headlines in 2019, from protests in Hong Kong to the U.S. President's impeachment, had little lasting impact on broad markets. However, several evolving issues weighed on economic growth, sentiment, or both this year. Stock market volatility has tracked closely in 2019 with shifting hopes and fears over resolution of the trade dispute between the U.S. and China. The dispute's economic impact has been felt globally, but particularly in emerging Asia, as international trade slowed and the potential for a wholesale resolution of trade tensions faded. Also, Brexit continued to weigh on European markets, helping underscore the relative strength of the U.S. in the current economic backdrop.

Trimming Asian Equity Exposure:

October 2019 – Reduced Asia equity exposure (particularly emerging Asia) in global portfolios, as valuations in the region had largely normalized and ongoing U.S./China trade tensions remained a material headwind. Proceeds from Asia were used to modestly increase our U.S. overweight.

Overall, 2019 has been a strong year for global markets as the economic cycle continued to mature. We look forward to sharing our updated outlook with you at the start of 2020.

WestEnd Advisors Investment Team | December 17, 2019

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The MSCI ACWI consists of 49 country indexes comprising 23 developed and 26 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 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.

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