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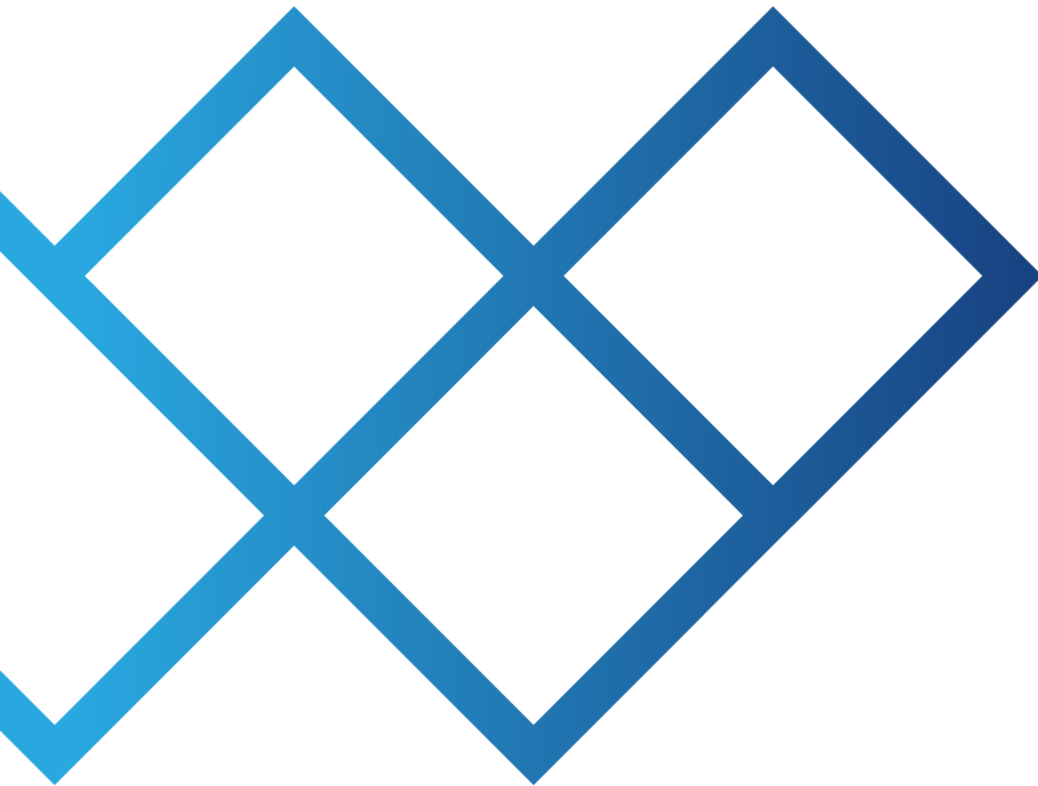

Macroeconomic Highlights

Q1 2020

WESTEND Advisors

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WestEnd Outlook Highlights

- We anticipate positive economic growth and market returns in 2020, though moderate growth faces risks and equity returns are unlikely to match 2019 levels.
- We expect positive equity returns in 2020 to be driven by moderate earnings growth, as valuations are at cyclical highs.
- We continue to avoid the most economically-sensitive U.S. equity sectors, allocating instead to sectors with more potential for stable earnings growth.
- International economies and markets still face uncertainty from Brexit and the ongoing U.S./China trade dispute – a limited trade deal is unlikely to bail out EM Asia and other trade-dependent regions.
- With continued late-cycle growth and low absolute yields, bonds offer portfolios stability, but are unlikely to provide strong returns in 2020. We favor investment-grade corporate bond exposure in fixed-income allocations.

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U.S. Equity Sector Allocations

WESTEND ETF STRATEGIES

U.S. Equity Sector Allocations as of December 31, 2019

Sectors Allocated/Overweighted

- Communication Services
- Consumer Discretionary
- Consumer Staples
- Health Care
- Information Technology
- Utilities

Sectors Avoided

- Energy
- Financials
- Industrials
- Materials
- Real Estate

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U.S. Economic & Market Backdrop

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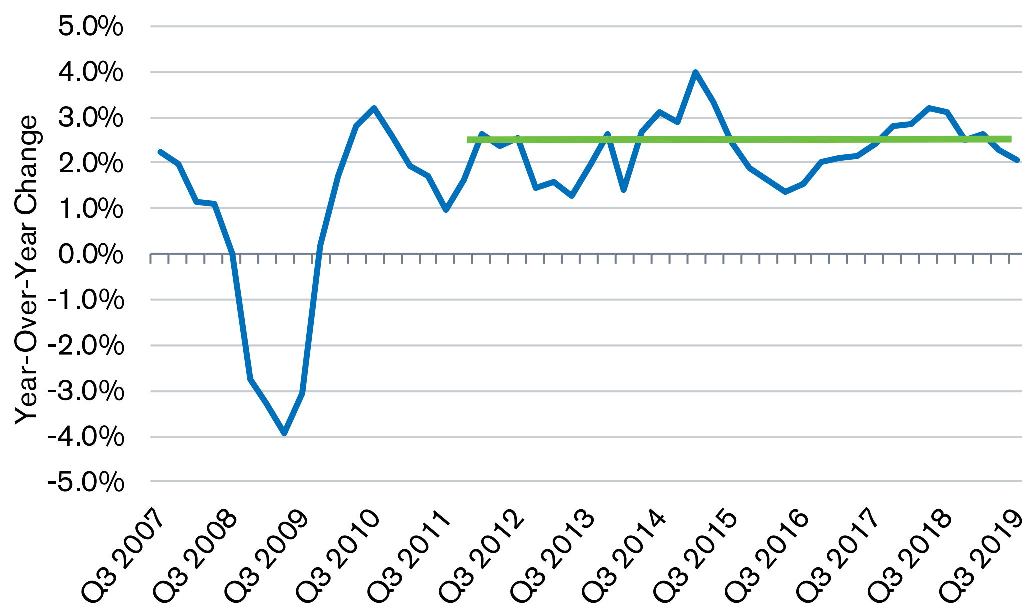
U.S. Economy Remains in Moderate Growth Range



Source: Bureau of Economic Analysis, WestEnd Advisors

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 should deliver steady earnings growth and can benefit from secular growth drivers.

Real GDP growth has decelerated over the last year in the U.S. In fact, the chart above indicates that the 2.1% year-over-year growth as of Q3 2019, which is the most recently reported quarter, was the slowest gain in nearly 3 years. Q4 GDP growth is expected to be close to 2%.

U.S. GDP likely grew a little over 2% for the full year 2019, and we expect that the U.S. economy will deliver a similar moderate pace of growth in 2020.

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Economic Data Points to a Mature U.S. Cycle

INITIAL JOBLESS CLAIMS

Source: Bureau of Labor Statistics, WestEnd Advisors

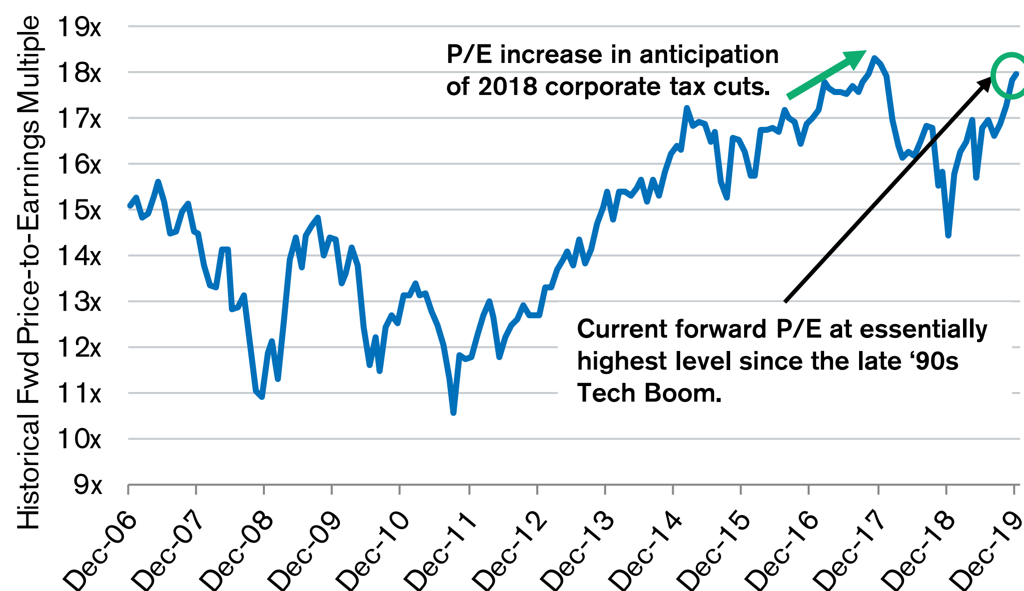
Portfolio Impact: A more advanced economic cycle and moderate growth demand being selective within both equity and fixed income asset classes to identify attractive investment opportunities.

Energy & Materials Sectors: In equity allocations, avoid more economically-sensitive sectors that typically benefit from dynamic economic growth.

Economic readings from various segments of the U.S. economy indicate the U.S. economy has made significant progress from the cyclical low. **Many of these indicators are at levels consistent with late cycle environments in previous cycles.** Initial jobless claims, in fact, are essentially at a 47-year low and at a level well below the readings recorded in tight labor markets prior to previous recessions. At the same time, as the chart above illustrates, jobless claims have stopped declining, a pattern consistent with the latter stages of an economic cycle.

These indications of a mature cycle warrant close attention, but **our base case continues to be for the U.S. economy to grow at a moderate pace in the quarters ahead.**

Valuation Jump Drove Equity Returns in 2019



Source: Bloomberg, WestEnd Advisors

Portfolio Impact: The U.S. stock market can generate positive returns in 2020, but significant P/E expansion is highly unlikely. Returns will come from sectors that can generate reliable earnings growth in our view.

We see sectors like **Information Technology** and **Health Care** as well-positioned given their exposure to both cyclical and secular drivers of earnings growth.

The S&P 500's price-to-earnings (P/E) ratio is back to cycle highs after the multiple expansion that occurred in 2019. The S&P 500's forward P/E ratio rose 27% in 2019, while it is expected that 2019 S&P 500 EPS will grow only 0.3% compared to the prior year.

A portion of the increase in equity valuations in 2019 is attributable to a rebound from the sharp sell off in stocks in Q4 of 2018. However, the chart above shows that P/Es are at the highest point of this cycle, excluding the period in 2017 when the market began discounting the corporate tax cuts before analysts updated their estimates. Today, there is no prospect for major corporate tax cuts, interest rates have fallen substantially compared to the end of 2018, and late-cycle challenges to economic growth are abundant. **All these factors indicate that a repeat of the multiple expansion of 2019 is unlikely** – and a steady or declining P/E would be consistent with history, since the S&P 500 has not delivered back-to-back 10%-or-more increases in P/E since 1998.

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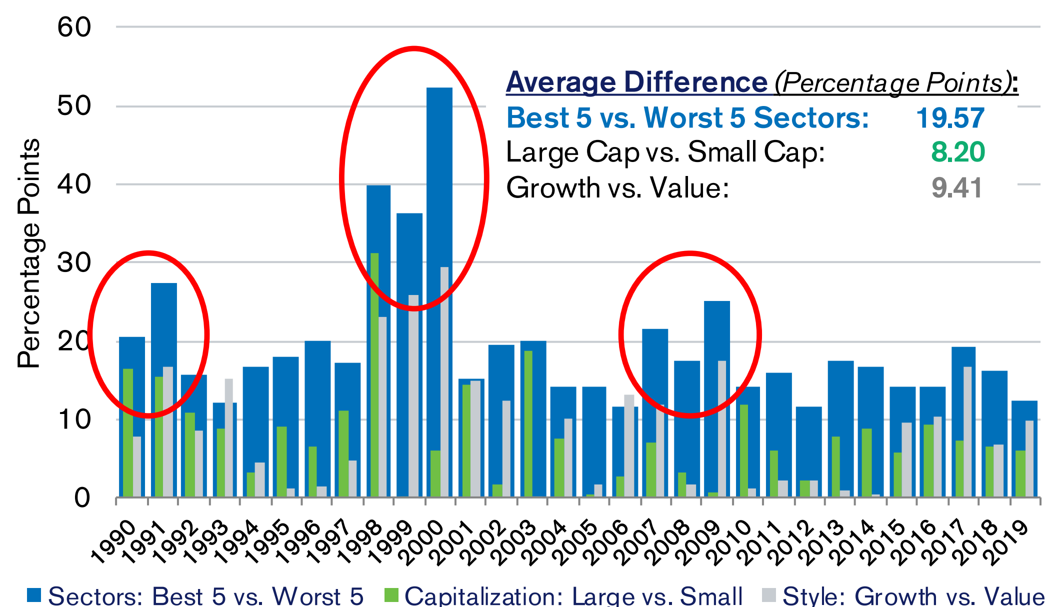
Sector Dispersion Typically Rises at Cyclical Turns

Portfolio Impact:

Sector allocation provides a powerful tool in portfolio construction. We continue to have significant allocations to sectors of the S&P 500 that should benefit from economic tailwinds, and we are avoiding other more economically sensitive parts of the U.S. market that typically fair poorly in a late-cycle environment.

RANGE OF RETURNS BY SECTOR, CAPITALIZATION, STYLE



Source: FactSet, WestEnd Advisors

Please see additional disclosures on page 24.

The average differences among segments of the market over the last three decades indicate that dispersion of returns among sectors may provide greater alpha generation opportunity than style allocation factors (growth vs. value, capitalization ranges).

While the power of sector investing typically holds up throughout the economic cycle, **sector performance spreads have typically increased near the end of the cycle**, as highlighted by the circles in the chart above.

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U.S. Sector Outlook

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The Consumer Continues to Drive the U.S. Economy

Portfolio Impact:
Consumers are a key aspect of U.S. economic growth, and consumer spending continues to grow, supported by record-low layoffs and solid personal income growth.

The health of the consumer warrants exposure to the **Consumer Discretionary** & **Consumer Staples** Sectors.

Source: U.S. Census Bureau, WestEnd Advisors

A healthy U.S. labor market is supporting workers' sense of job security and income gains, both of which, in turn, support consumer spending. Wage and salary growth for workers was up 5.3% year-over-year as of November, and Initial Jobless Claims are near a 47-year low.

Core Retail Sales have grown between 4% and 5% year-over-year in recent quarters, led by sales at non-store retailers (e-commerce), which were up 13% year-over-year for the three month period ended November.

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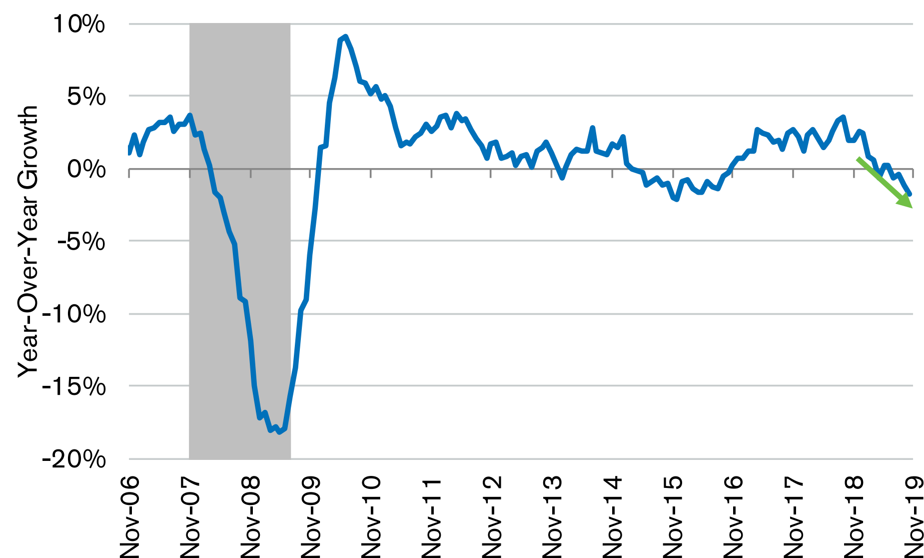
Industrials Sector Faces Challenges

The U.S. economy continues to grow at a moderate pace, but performance is not uniform across the economy. While consumer spending has been healthy, recent data indicate that the production portion of the U.S. economy has been weak.

Manufacturing production growth turned negative in 2019, as slower business investment and international trade challenges have hampered activity. In addition, commercial construction has slowed substantially, leading to slower nonresidential construction overall. The 16% year-over-year decline in commercial construction as of October, and lower construction spending in general, have hurt manufacturing activity as well.

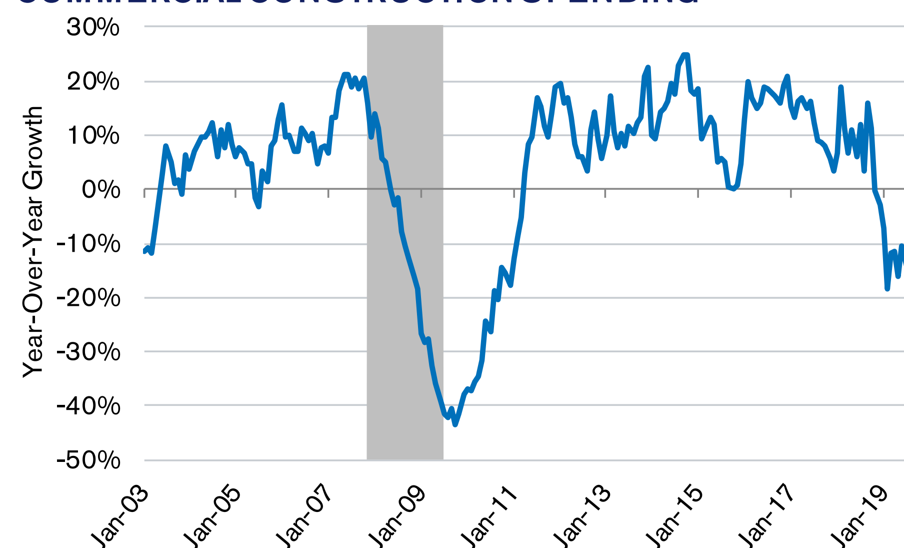
Portfolio Impact: Progress in the U.S. economic cycle along with an outlook for unexciting global growth warrants **avoiding U.S. Industrials Sector** stocks.

MANUFACTURING PRODUCTION



Source: Federal Reserve WestEnd Advisors

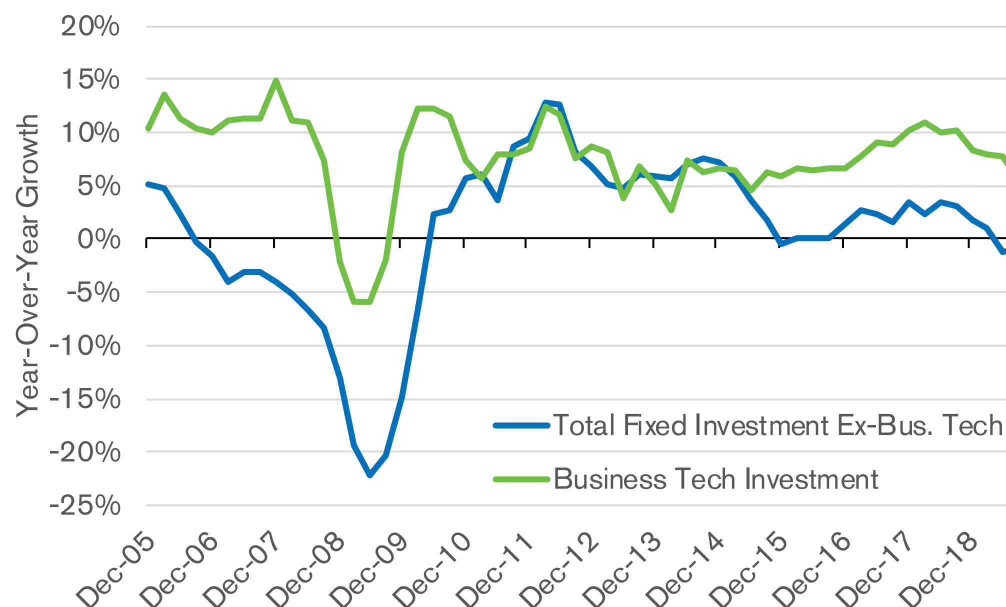
COMMERCIAL CONSTRUCTION SPENDING



Source: U.S. Census Bureau, WestEnd Advisors

Business CapEx Drives Technology Sector Growth

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.



Source: Bureau of Economic Analysis, WestEnd Advisors

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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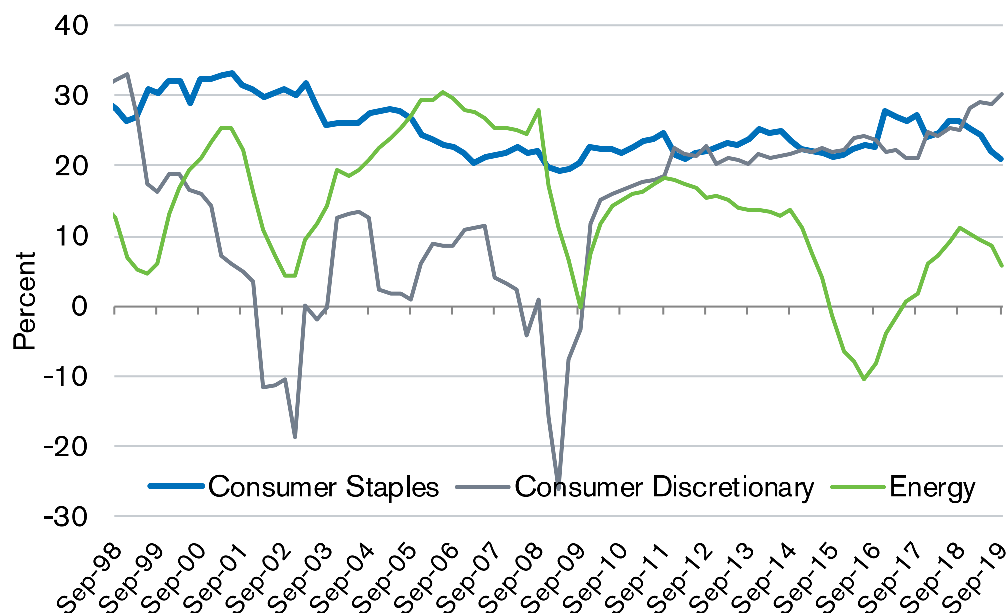
Staples Sector Companies Provide Steady Earnings



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 consistently 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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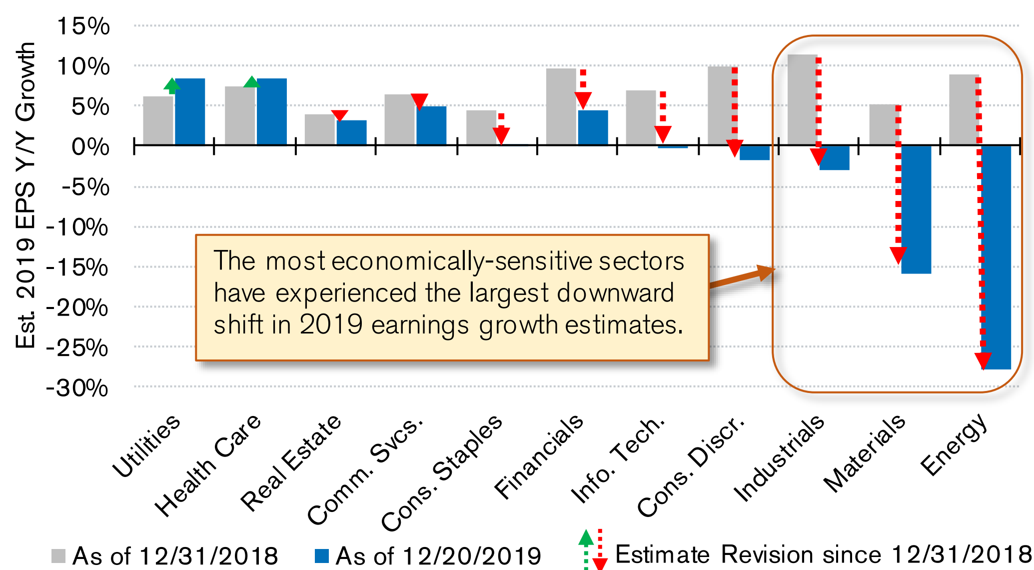
Cyclical Sectors See Biggest Earnings Revisions



Source: FactSet, WestEnd Advisors

Portfolio Impact: Given our outlook for continued maturing of the economic cycle, we are currently avoiding the most economically-sensitive U.S. equity sectors. Risks to economically-sensitive sectors are evidenced by downward revisions to earnings growth estimates for 2019.

Since the beginning of 2019, Energy, Materials, and Industrials have seen the largest cuts in expected earnings growth for 2019. The Energy and Materials Sectors are now expected to show double-digit earnings declines in 2019 (compared to growth of 5% and 9% that was expected at the start of the year for these sectors).

Consensus estimates assume the economically-sensitive Energy, Materials, and Industrials sectors will drive nearly 10% EPS growth for the S&P 500 in 2020. With a slowing economy, we believe these sectors are very likely to disappoint against investors' elevated expectations, as they did in 2019. For example, **consensus estimates for Energy sector 2020 earnings growth have already fallen by about a third since September, from 31% to 21%.**

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International Economic & Market Backdrop

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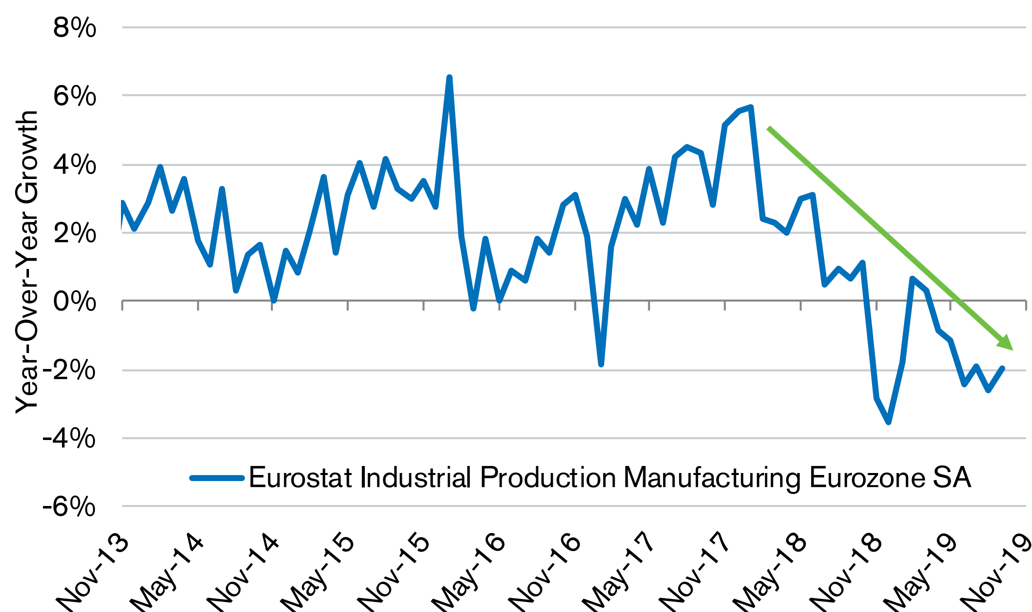
Manufacturing Weakness Weighs on European Growth



Source: Eurostat, WestEnd Advisors

Portfolio Impact: Developed Europe experienced a step down in growth in 2019. Headwinds that could slow growth further in 2020 include global trade adjustments, more Brexit uncertainty, and maturing of the global economic cycle, all of which warrant an underweight of European equities.

Europe's weak GDP growth has centered in the manufacturing and international trade portions of the region's economy. Temporary events, such as regulatory disruption to the auto industry, were partly to blame for softer growth in the second half of 2018, but declines in manufacturing and trade intensified in 2019. Causes for a snapback in growth are limited.

Germany, a manufacturing leader, has been a key driver of the overall European weakness. China's economic slowdown is cited as a contributor to Germany's slowdown, yet exports to China only account for 8% of total German exports. We believe Brexit uncertainty and global trade adjustments have also contributed to the struggles for Germany's industrial sector.

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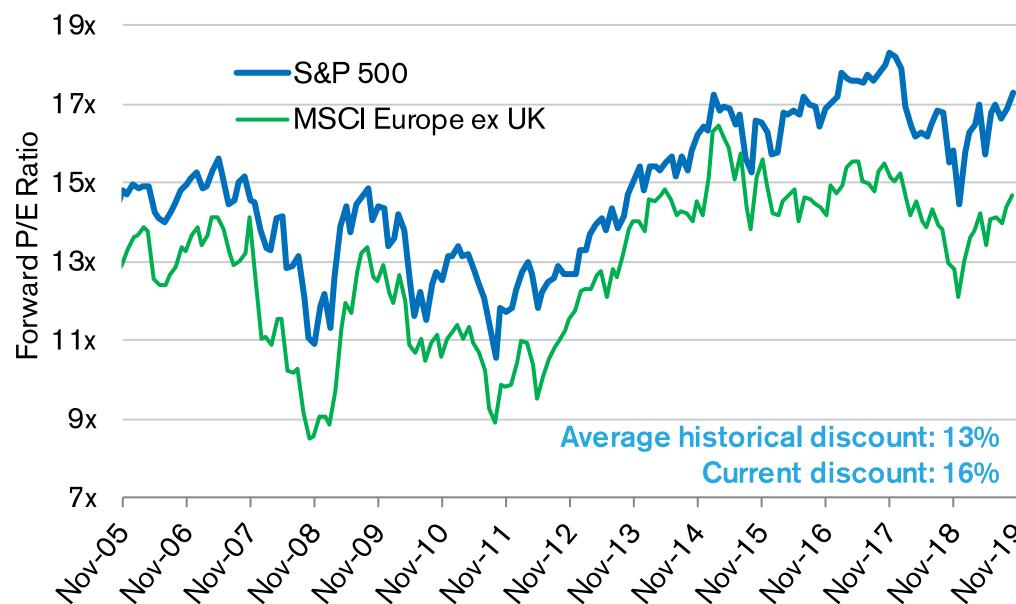
European Valuations: Near Normal Discount to U.S.

Portfolio Impact: European equity valuations have risen sharply in 2019, but remain below U.S valuations. Challenged European economic fundamentals and a near-average discount to U.S. equities warrant limited exposure to European equities.

EUROPE (EX-UK) DISCOUNT TO U.S.



Source: Bloomberg, WestEnd Advisors

European equities performed strongly in 2019, returning over 24% in USD terms, while earnings growth was much more subdued, resulting in higher European equity P/E valuations. As such, **European equities are not cheap when analyzing P/E valuations against their own history and relative to U.S. P/E's** (see chart above).

Looking ahead, we forecast that 2020 European earnings growth will come in below expectations and below that of the U.S., yet again. This forecast is in part driven by the prominence of the Financials and Industrials Sectors in Europe, which together make up over 30% of the MSCI Europe Index. These sectors are economically sensitive and continue to face headwinds in Europe including Brexit uncertainties and global trade adjustments.

Phase 1 Deal Reverses Only a Small Portion of the Tariff Damage – Trade Tension to Persist

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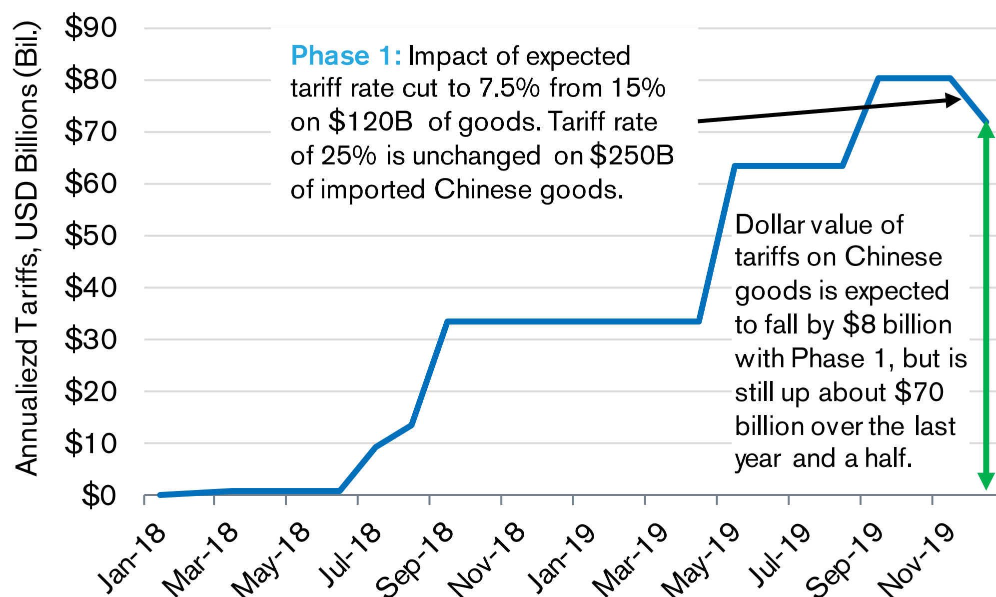
ANNUALIZED TARIFFS ON IMPORTS FROM CHINA



Source: U.S. Trade Representative, WestEnd Advisors

Portfolio Impact: The Phase 1 trade deal between the U.S. and China provided some positive momentum in negotiations and some sentiment relief for investors in 2019. We expect that positive momentum will be hard to sustain in 2020, and thus an underweight of trade-sensitive Emerging Asia is warranted.

In December 2019, the Trump Administration and the Chinese government announced what is being referred to as "Phase 1" of the trade deal. Under Phase 1 the U.S. is expected to cut the tariff rate on $120B of goods imported from China to 7.5% from 15%. The tariff rate on another $250B of goods, however, will remain unchanged at 25% under the deal. The dollar value of the tariffs on Chinese goods is expected to fall by $8 billion with the Phase 1 deal, but **the value of the tariffs is still up about $70 billion over the last year and a half,** as illustrated in the chart above.

We don't see the Phase 1 deal having a major impact on the global economy, as tariffs remain high, Chinese commitments to buy U.S. goods will be very difficult to achieve, and the Huawei issue is unlikely to be resolved. **We also expect negative rhetoric about China as a trade partner to ratchet back up in an election year, rattling markets and making a Phase 2 deal unlikely.**

Emerging Asia Will Not be Bailed Out by Phase 1Trade Deal

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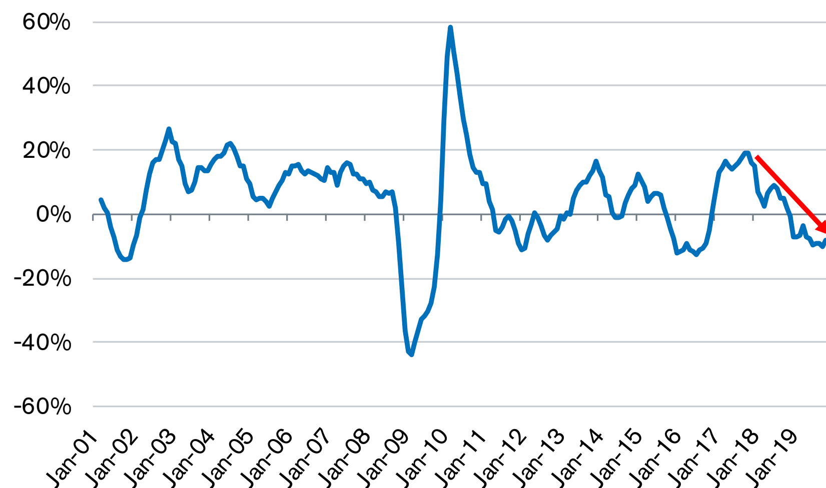
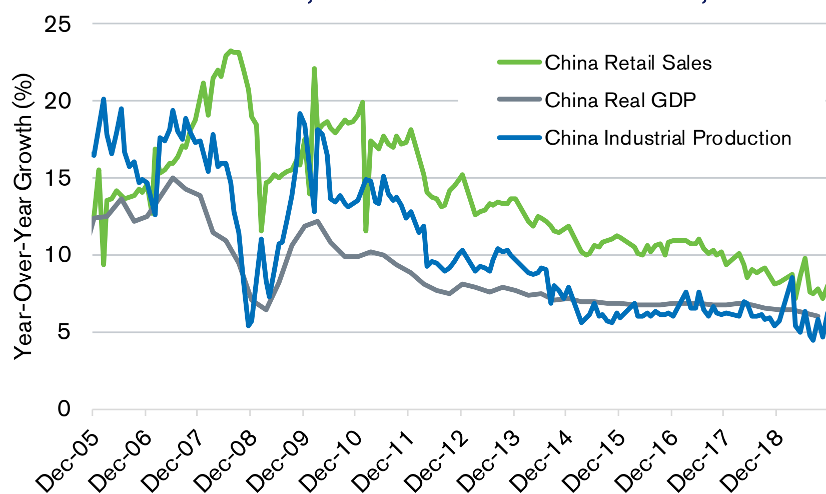
JAPAN EXPORTS TO ASIA (Y/Y GROWTH)



Source: Ministry of Finance Japan, WestEnd Advisors

CHINA RETAIL SALES, INDUSTRIAL PRODUCTION, REAL GDP



Source: National Bureau of Statistics, WestEnd Advisors

Portfolio Impact: Indirect economic damage from ongoing trade disputes and global growth uncertainty is evident in all EM Asia economies, not just China. Signs of stabilization are emerging, although a strong rebound akin to 2017 is unlikely, even in the event of a trade deal. China's growth continues to glide lower, and EM Asia equity valuations are rich by historical standards.

Trade amongst EM Asia has slowed substantially since Q3 2018. China is a major trade force in EM Asia, but we see that China trade is not the only driver of the region's slowdowns. **Japan's exports to all EM Asia, an indication of demand among EM Asia economies, are down year-over-year in JPY terms**, indicating a widespread slowdown (see top chart).

Still, China has *in the past* been a major engine of growth. A reluctance from Chinese leadership to unleash more credit (as the PBOC did in 2016) reduces the likelihood of substantial EM Asia growth reacceleration, particularly as **China's economic growth path continues to glide lower** (see lower chart). Meanwhile, EM Asia equity valuations are one standard deviation above their historical average, as well.

Interest Rates & Inflation

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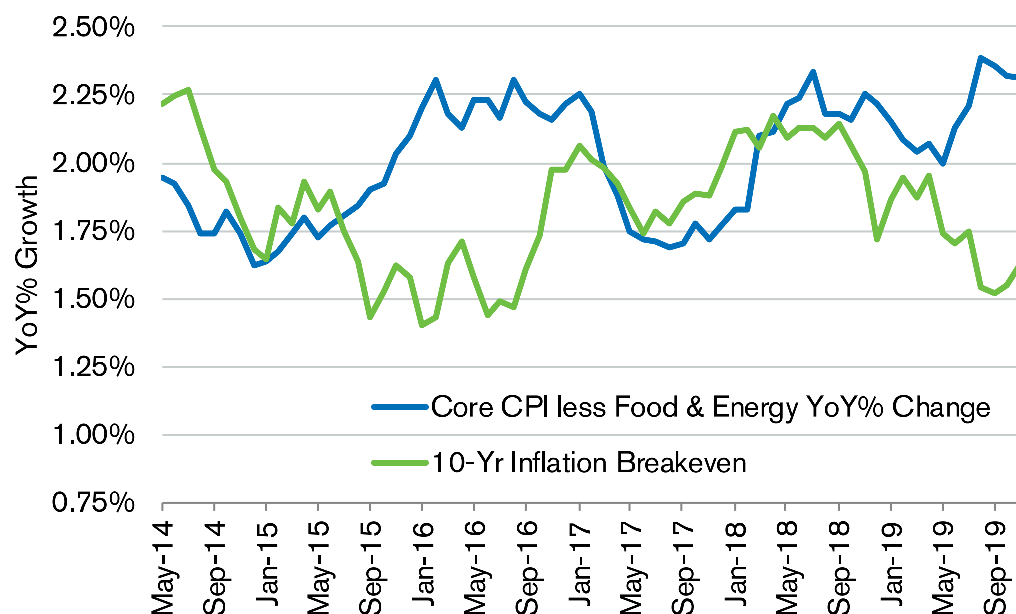
Inflation Pickup as Growth Outlook is Subdued



Source: Bureau of Labor Statistics, Bloomberg, WestEnd Advisors

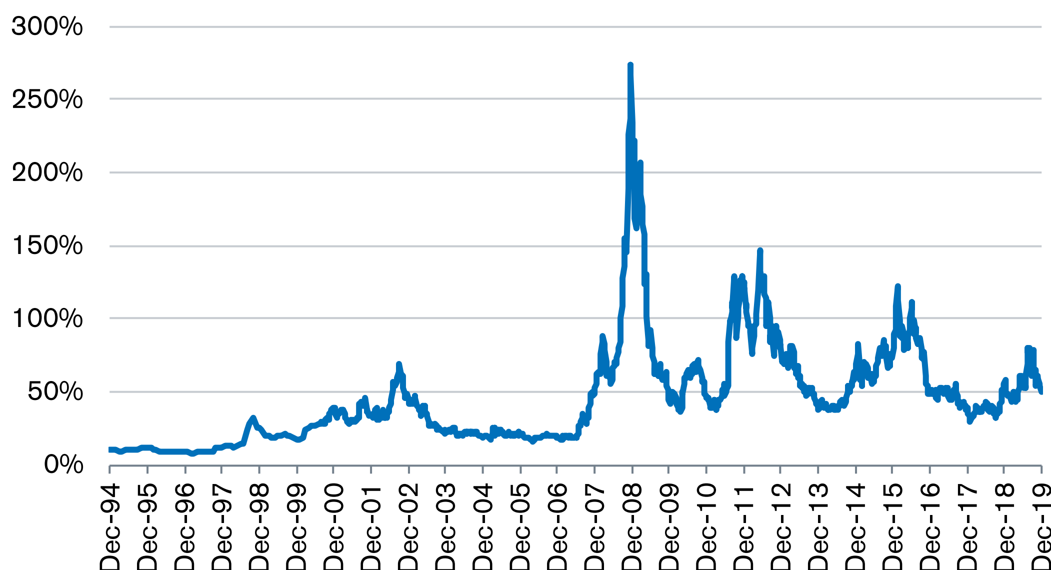
Portfolio Impact: Inflation expectations shifted lower in 2019. An outlook for steady growth along with hotter inflation readings more recently indicate inflation expectations are likely to move higher. **TIPS** allocations would benefit from higher inflation expectations.

Inflation data indicate higher levels of price increases in recent months, but at the same time, inflation expectations are below the levels seen in 2018, and even early 2019. One measure of inflation expectations, the breakeven rate, can be derived by comparing yields on traditional fixed-coupon Treasury bonds and Treasury Inflation Protected Securities (TIPS).

Hotter inflation data should support higher inflation expectations, but the Fed is likely to tolerate the uptick in inflation without hiking the Fed Funds rate. **A stable interest rate environment coupled with rising inflation expectations is an attractive market for TIPS.**

Slow-To-Moderate Growth Positions Investment-Grade Corporate Bonds Favorably

Portfolio Impact: With an outlook for continued economic growth along with low absolute yields, **we favor investment-grade corporate bond exposure** over allocations to Treasury bonds in fixed-income allocations.



Source: Bloomberg, WestEnd Advisors

U.S. Treasury bonds performed strongly for investors in 2019, with U.S. interest rates at one point falling to levels not seen since Q3 2016. As of year-end 2019, 10-Year Treasury bonds yielded ≈1.9%, while U.S. investment grade (IG) corporate bonds yielded ≈2.9%. Looking to 2020, we forecast U.S. interest rates to be relatively stable. This is supported, in part, by continued slow-to-moderate growth in the U.S., in addition to minimal policy action from the FOMC.

With rates remaining near current levels and corporate balance sheets healthy, we prefer IG bonds versus Treasuries due to higher yields (IG corporate bonds currently yield 50% more than Treasuries). Also, corporate bonds should perform better if interest rates rise, as higher real growth and/or higher inflation expectations generally are positives for corporate bonds and equities vs. Treasuries.

Footnotes & Disclosures

This report should not be relied upon as investment advice or recommendations, and is not intended to predict the performance of any investment. Past performance is not indicative of future results. It should not be assumed that recommendations made in the future will be profitable. The information contained herein is not intended to be an offer to provide investment advisory services. Such an offer may only be made if accompanied by WestEnd Advisors' SEC Form ADV Part 2. 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. The information has been gathered from sources believed to be reliable, however data is not guaranteed.

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 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 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.

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Footnotes & Disclosures (cont.)

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 26 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.

On page 8, sector performance is represented by sectors of the S&P 500® Index. "Large Cap" is represented by the S&P 500® Index. "Small Cap" is represented by the Russell 2000® Index. "Growth" is represented by the Russell 1000® Growth Index. "Value" is represented by the Russell 1000® Value Index. Data for 2016 excludes Real Estate as a stand-alone sector, which was included in Financials until September 16, 2016. Data for 2018 replaces the Telecommunication Services Sector with the new Communication Services Sector after September 21, 2018, using geometrically-linked total returns to produce a single full-year return, and treats the linked returns as a single sector, due to changes in GICS sector classifications and index rebalancing that occurred as of market close on September 21, 2018.