Easing Off the Gas, Not Slamming the Brakes

Our outlook for the U.S. remains positive. However, slowing growth, progress already made this economic cycle, and a partially-inverted yield curve demand close attention. As this expansion continues to mature, we believe a mix of economically-sensitive and defensive exposures is appropriate for the environment ahead.

Summary

- Trade tensions, decelerating economic momentum, and a partial inversion of the U.S. yield curve contributed to further equity market volatility in Q2 2019.
- 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.

Q2 2019 Review

Global markets remained volatile in Q2 2019. Nonetheless, overall equity returns were consistent with a continued bull market, as the MSCI ACWI returned 3.6%. An escalation of trade tensions seemed to depress global equity returns mid-quarter, as, among other things, the Trump administration increased tariffs on certain Chinese goods from 10% to 25% in May. The S&P 500 returned 4.3% in Q2, outperforming most international equity markets in U.S. dollar terms, even as parts of the U.S. Treasury yield curve inverted amid signs of decelerating economic growth.

While headline U.S. GDP growth from Q1 reached 3.1%, almost half of that growth came from Net Exports and Inventories, categories which are volatile and likely provide only a short-term boost to reported growth. Private end demand, as measured by real final sales to private domestic purchasers, grew at only a 1.3% annualized pace in Q1 and likely at a similar pace in Q2.

Within U.S. equities, Financials (which we held until late in the quarter) was the best-performing sector in Q2, followed by Materials, and then Information Technology, which benefits from cyclical and secular tailwinds. Energy was the worst-performing sector, as oil prices fell amid slowing global economic growth and continued U.S. supply growth, despite a late-quarter rally as geopolitical tensions with Iran escalated. Meanwhile, defensive U.S. sectors, such as Health Care and Utilities, underperformed in Q2 as optimism for a potential resumption of U.S./China trade talks boosted economically-sensitive sectors late in the quarter.

Treasury and corporate bond prices rose as longer-term interest rates fell in Q2. Corporate interest rate spreads remained relatively stable and in line with their long-term average.

Focus on U.S. Sectors That Benefit From:

- *Both cyclical and secular tailwinds, like Info. Tech. and Comm. Services*
- *Stable earnings growth, like Consumer Staples, Health Care, and Utilities.*

Outlook

We expect moderate economic growth to continue in the U.S. in the near-to-intermediate term, but our outlook incorporates a deceleration in growth as the cycle continues to mature. We have already seen signs of slowing manufacturing and construction activity in 2019. The consumer, however, remains a source of relative strength that should support continued expansion, with personal income and spending each still growing more than 4% year-over-year.

The recent flattening and partial inversion of the yield curve is a new development during this economic expansion and is, in our view, unsustainable. Given slowing economic growth and sub-2% inflation, Fed rate cuts seem increasingly likely as a path toward a normal, upward-sloping yield curve.

We believe the yield curve is a useful indicator of economic strength, and currently suggests late-cycle expansion with room for growth rather than an impending recession or extended bear market. While short-term T-bills recently inverted compared to the 10-year Treasury, the more market-driven 2-year note has not. Each of the last four multi-year economic expansions has continued for between 16 and 33 months after the 2 vs.10-year Treasury spread inverted. Given our investment process has a 6 to 18 month outlook, it is worth noting that the 18-month return for the S&P 500 exceeded 19% following each of these inversions.

Internationally, tariffs have weighed on global trade. For example, April data showed imports of goods to the U.S. from China were down 19% from September 2018, when a 10% tariff was imposed on an additional $200 billion of Chinese goods. These trade developments present additional headwinds for interconnected European and Asian economies already facing cyclical and structural challenges. While U.S. economic growth has slowed this year, the U.S. remains on favorable footing compared to these regions, as illustrated in earnings estimate revisions. By late June, S&P 500 consensus estimates for 2019 earnings had fallen about 2% from the start of the year, but 2019 earnings estimates were down about 4% for Europe and more than 7% for China and Japan.

Our interest rate outlook has evolved with the economic and market data. In fixed-income allocations, we have eliminated floating-rate exposure and lengthened average duration, given increased potential for interest rate cuts. We remain materially overweight corporate bonds, given our outlook for continued moderate economic growth, but have also added Treasury securities within our longer-duration fixed-income exposure.

We have positioned our portfolios for the likely economic and market environment we anticipate, and we look forward to providing ongoing updates as our outlook evolves.

WestEnd Advisors Investment Team | July 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.

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.