WestEnd ADVISORS

Economic and Market Commentary

Q3 2019

A Tale of Two Economies: Consumer vs. Producer

U.S. economic growth is likely to remain positive, but below trend, in the near-to-intermediate term, as consumer strength is partly offset by weakness in manufacturing industries. We anticipate continued market volatility in the face of a maturing U.S. economic cycle, economic weakness abroad, and geopolitical uncertainty.

Summary

- Global capital markets remained volatile in Q3, with mixed performance across equity sectors and regions.
- The U.S. economic cycle continues to mature, with positive but decelerating growth as consumer strength is partly offset by weakness in manufacturing.
- The Federal Reserve's two recent short-term rate cuts should help normalize the yield curve but are unlikely to spur a sustained reacceleration of economic growth.
- We continue to avoid the most economically-sensitive U.S. equity sectors and underweight international equities.

Q3 2019 Review

Signs that the U.S. economic cycle is maturing continued to accumulate in Q3. Employment gains slowed, the spread between 2-year and 10-year Treasury yields temporarily inverted, and the Federal Reserve deemed it appropriate to cut the Fed Funds target rate twice (its first cuts in over a decade). Yet, the resilience of the U.S. economy was also on display in the face of ongoing uncertainty over international trade, escalating tensions in the Middle East, and dislocations in the overnight lending market. The U.S. consumer continued to see income gains and spending growth accelerated in Q3, though consumer strength was partly offset by weakness in manufacturing.

Global capital markets remained volatile in Q3, with mixed performance across equity sectors and regions. U.S. equities outperformed most international markets, with the S&P 500 returning about 1.7%. U.S. sectors with the highest economic sensitivity, like Industrials, Materials and Energy, generally under-performed in Q3, despite a sharp rally in September amid renewed hopes for resolution of the U.S.-China trade dispute.

Avoiding U.S. Sectors Most Dependent on Growth:

- *Slowing late-cycle economic growth is a headwind for Industrials, Materials, and Energy equities.*
- *International trade tensions are also a headwind for these sectors, but resolution of tensions is unlikely to provide them a sustained boost.*

Yields on longer-term Treasury bonds fell sharply in the weeks following the first Fed Funds rate cut in July, leading to a temporary inversion of the yield curve as measured by the spread between 2-year and 10-year Treasury yields, the first such inversion this cycle. However, the 2-10 spread turned positive again at the end of the quarter as markets seemed to price in additional short-term rate cuts and core inflation showed signs of a pick-up. Still, longer-term Treasury bonds outperformed equities in Q3, and corporate bonds also performed well as the spread between corporate and Treasury bond yields narrowed modestly.

Outlook

While U.S. economic growth is likely to remain below trend, we expect growth to remain positive in the near-to-intermediate term. A reacceleration of consumer spending in Q3 accentuated the recent divergence between the consumer and manufacturing portions of the U.S. economy. Consumers remain an important driver of U.S. economic growth, with core retail sales growth above 5% year-over-year as of August, supported by record-low layoffs and wage and salary growth that is at the high end of the range seen this expansion. Consumer strength, even as job growth slows, provides stability for the U.S. economy as a whole.

In contrast, the more-cyclical production side of the economy has slowed. For example, when demand weakens, businesses typically cut workers' hours before laying off employees, and weekly hours worked for manufacturing employees have recently trended down near their lowest level in seven years. Additionally, 2019 earnings expectations for the Industrials, Materials, and Energy sectors have been revised down sharply. While slowing economic growth has weighed on earnings estimates for almost every sector this year, expectations for these very economically-sensitive sectors have been the hardest hit. This aligns with our current outlook and equity sector positioning. We are avoiding the U.S. Industrials, Materials, and Energy sectors, which typically face increased relative risks as economic growth slows.

We expect the U.S.-China trade dispute will continue to weigh disproportionately on the U.S. Industrials and Materials sectors, as well. However, given the mature economic expansion and the limited impact of trade tensions on the broader economy (thanks, in part, to offsetting weakness in the Chinese yuan), we do not expect the eventual resolution of trade issues to be a catalyst for robust global economic growth that would favor these sectors.

Overseas, while we still see better opportunities in Asia than Europe, we continue to underweight international equities as a whole. European economic data has deteriorated in 2019, with notable weakness in German manufacturing, and uncertainty over Brexit remains a major headwind for the region. In Asia, Japan has seen some strength in corporate profitability and capital expenditures, and continues to have a strong labor market, while Chinese growth remains low by historic standards.

The Federal Reserve's recent short-term rate cuts should help normalize the yield curve. They are unlikely, however, to mark the start of a prolonged easing cycle or spur a significant and sustained reacceleration in economic growth. However, with continued late-cycle growth and low absolute yields, we still favor corporate bond exposure in fixed-income allocations.

We expect global economic growth will remain positive in the near term, but that markets will remain volatile. We are mindful of signs that the economic and market cycle continues to mature, and we will adjust portfolios as needed as our outlook evolves.

WestEnd Advisors Investment Team | October 1, 2019

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