WESTEND Advisors

Economic and Market Commentary

Q4 2019

Cautious Optimism for 2020

We anticipate positive economic growth and market returns in 2020, though moderate growth faces risks and equity returns are unlikely to match 2019 levels.

SUMMARY

- Global markets surged in 2019, driven by rising valuations and falling interest rates as major economies slowed.
- U.S. economic growth should continue in 2020, though potentially below the current trend.
- International economies and markets still face uncertainty from Brexit and the ongoing U.S./China trade dispute.
- We expect positive equity returns in 2020 to be driven by moderate earnings growth, as valuations are at cyclical highs.
- With interest rates near historic lows, bonds offer portfolios stability, but are unlikely to provide strong returns in 2020.

2019 REVIEW

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 healthy labor market, with a 50-year low in unemployment and modestly accelerating wage growth, supported personal consumption in 2019. However, industrial production declined, private construction spending growth was negative, and business investment slowed.

The fourth quarter of 2019 provided a strong finish to a strong year for global equity markets. **Forward P/E valuations expanded materially in 2019, partly driven by declining interest rates.** The MSCI ACWI returned 26.6% in 2019. U.S. equities outperformed most international regions, as economic growth abroad faced stronger headwinds from geopolitical issues, ranging from Brexit uncertainty in Europe to a drag on Asian economies from the U.S./China trade dispute. Asian stocks, however, saw significant valuation expansion along with most regions in 2019, and we chose to pare back our global portfolios' already-underweighted exposure to Asia in Q4. We used the proceeds to modestly increase our U.S. overweight.

Sector performance in the U.S. was mixed, with below-average dispersion among sectors, as all sectors participated in the major stock market rally. Some sector moves reflected fundamental economic factors, while others seemed more influenced by politics and sentiment. Information Technology was the best-performing U.S. sector in 2019, as secular technology trends remained favorable. Despite higher oil prices, Energy was 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 defensive characteristics, though it did outperform in Q4 as regulatory uncertainty eased.

The U.S. interest rate environment evolved significantly in 2019. 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. Corporate investment-grade bond yields also declined, and their spreads versus Treasury bonds narrowed as moderate economic growth continued. Rates remain very low, and **the yield curve remains flat by historical standards**.

2020 OUTLOOK

Our outlook for 2020 is cautiously optimistic. Global economic growth and market returns should remain positive, though growth faces risks and equity returns are unlikely to match 2019 levels.

Confident consumers
Workers are quitting at record levels, indicating confidence in the job market.

The U.S. remains the bright spot of this mature economic cycle, led by a strong consumer. Very low unemployment and rising wages are supporting consumption, and workers are quitting jobs to find new employment at a record pace. We believe **economic growth can persist if the U.S. consumer remains confident**, even as recent slowdowns in manufacturing, construction, and industrial CapEx continue to whittle away at the pace of U.S. growth.

Earnings growth should provide the basis for positive U.S. equity returns in 2020. Aggregate earnings per share for the S&P 500 are widely expected to grow at a near-double-digit pace in 2020, after a lull last year. However, consensus estimates assume the most growth from the economically-sensitive Energy, Materials, and Industrials sectors. With a challenged economy, we believe these sectors are very likely to disappoint versus elevated expectations, as they did in 2019. In fact, estimates for Energy sector 2020 earnings growth have already fallen from 31% to 21% since September.

We are avoiding highly cyclical U.S. sectors
Energy, Materials, and Industrials are likely to fall short of elevated earnings expectations.

We currently favor U.S. sectors that can provide stable earnings growth in this sort of mature economic environment. For example, Technology companies should continue to benefit from secular adoption of cloud computing and digital payments, as well as late-cycle tech CapEx as companies seek to boost productivity. Health Care companies with robust pipelines and some of the lowest relative valuations can reduce portfolio risk amid market volatility. Also, the Consumer Staples and Utilities sectors have highly stable fundamentals and earnings growth, which investors are likely to find increasingly attractive as the economic cycle progresses.

Key Risks: Our U.S. outlook has upside and downside risks. One potential positive is a temporary pickup in headline manufacturing activity by mid-2020. Auto production has ramped back up following the GM strike, helping drive a rebound in manufacturing output in November, and Boeing is likely to resume production of its side-lined 737 Max airliner. While **a full resolution of the U.S./China trade dispute is unlikely** in our view, phased progress could provide a temporary boost to the global economy. However, we do not see these factors as catalysts for sustained economic reacceleration. On the downside, **weakness in the production side of the economy could spread**. We are watching economic data closely for signs of manufacturing weakness bleeding through to other industries. Margin compression is another risk in the U.S., as the tight labor market and ongoing trade disputes could squeeze profits through both increased costs and weaker end-demand.

With global equity valuations back near cyclical highs, we see little chance that the strong stock returns of 2019 repeat in 2020. **We expect increased volatility, along with increased dispersion among sector performance.** The 2020 Presidential election presents one source of potential short-term volatility, as a tightly-contested race could lead to sharp swings in sentiment. We believe, however, the most likely outcome is a divided government, which has limited fundamental risk for markets.

International equity valuations seem particularly optimistic, given macroeconomic headwinds abroad. While international consumers remain on solid footing, most major international economies are fairly reliant on investment and manufacturing, which have slowed. We believe expectations for earnings growth abroad assume an unlikely improvement in demand, in part from better global trade conditions. As such, we continue to underweight foreign equities.

As with equities, **the strong absolute bond returns of 2019 are unlikely to repeat in 2020.** Interest rates are historically low, and while modest inflationary pressures may put some upward pressure on longer-term rates, we do not anticipate aggressive easing by the Fed that would lower short-term rates materially. Fixed-income exposure, however, should remain a source of relative stability in balanced portfolios, where we continue to favor investment-grade corporate bonds in anticipation of moderate economic growth.

Following a strong year for global markets in 2019, we remain vigilant for both investment opportunities and risks. We look forward to updating you and welcome your questions as our outlook and portfolio positioning evolve over the coming year.

WestEnd Advisors Investment Team | January 2, 2020

Disclosures

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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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