Monthly Market Commentary
Transition Hits White House and Rates
November 2016

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- The U.S. presidential election enabled Republicans to consolidate control in the White House and Congress, helping to propel an advance in U.S. stocks for most of the month.
- Bond markets faltered globally as yields bounced off near-historic lows. Long-term government interest rates increased around the world and short-term U.S. Treasury rates rose on inflation expectations and the likelihood of a rate hike by the U.S. Federal Reserve in mid-December.
- We think the equity market advance could accelerate through 2017, particularly in the U.S., as campaign promises provide some assurance of policies that should help the U.S. economy at the expense of global trade.

Economic Backdrop

A tighter-than-expected U.S. presidential election ended with a rebuke of the establishment, enabling Republicans to consolidate control both in the White House and Congress. U.S. stocks responded positively for the most of the month after finding their footing, and then levelled off toward the end. U.K. stocks were down a bit overall after a choppy start to the month as a High Court ruling determined government plans to withdraw from the European Union would be subject to Parliamentary approval and European leaders hardened their Brexit negotiating stance; European stocks largely finished November where they started. Oil prices (WTI Cushing and Brent) finished the month on a high note after the Organization of the Petroleum Exporting Countries (OPEC) members put country-level specifics to a production-cut agreement first proposed in September.

Bond markets, however, faltered globally as yields bounced off near-historic lows. Long-term government interest rates increased around the world (yields move inversely to prices), and short-term U.S. Treasury rates increased as well, possibly due to a combination of anticipated inflationary infrastructure spending by the incoming administration and the likelihood of a rate hike by the U.S. Federal Reserve (Fed) in mid-December. The Fed and Bank of England (BOE) announced no changes following their respective early-November meetings on monetary policy, while the European Central Bank and Bank of Japan did not meet during the month.

U.K. sales volumes appeared set to improve again in November following a sizeable leap in October's retail sales report thanks to a broad-based advance, supporting the highest year-over-year reading since 2002. Manufacturing growth moderated in November, albeit with new orders and output still advancing, while rising input costs held back further improvement. Consumer prices inched upward in October; strength in motor-fuel and furniture and household equipment was offset by softness in clothing and footwear, recreation and culture, and education, which lagged sufficiently enough to lower the annual inflation rate. The unemployment rate fell in the three-month period ending September to the lowest point in over 10 years. However, the number of people working grew by only 49,000 — signalling a possible hiring slowdown. The latest U.K. gross domestic product (GDP) report was unrevised at 0.5% for the third quarter and 2.3% year over year.

Eurozone manufacturing activity continued to head in the right direction during November, reaching its best level in nearly three years, and a preliminary survey of services activity reported its best performance in almost a year. Consumer prices rose 0.6% during the year through November, according to an early report; while low, it continues a near-uninterrupted increase that began in the spring. Consumer sentiment improved in November, and industrial sentiment was mixed, although services-sector confidence held firm. The unemployment rate fell to 9.8% in October, its lowest level since mid-2009; youth unemployment failed to improve alongside the month-over-month gain, but was 1.5% lower than its year-ago level. Third-quarter GDP was reported at 0.3%, in line with the prior quarter's pace, and 1.6% year over year.

U.S. services growth continued apace in November, manufacturing growth continued to advance into more comfortable territory, and construction spending during October stood out as the best since January after a lacklustre performance for much of 2016. Jobless claims oscillated near the bottom end of their historical range in November, hitting their lowest level since 1973 early in the month but finishing with a relatively soft, albeit still very low, reading. The October unemployment rate fell back to 4.9% and prior month figures were improved on revisions, with average hourly wages growing by 2.8% year over year — the highest level since July 2008. Additionally, personal incomes rose by 0.6% in October, and September's reading was revised upward by 0.4%. Spending rose by 0.3% in October, as retail sales climbed by 0.8% alongside an upward revision to September's report, with auto sales leading in both months. Accordingly, personal consumption drove the latest reading of third-quarter GDP to an annualized 3.2%.

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All references to performance are in U.S. dollar terms unless otherwise noted.

Market Impact[1]

Global fixed-income markets stumbled in November, as reflected by the Bloomberg Barclays Global Aggregate Index, and major market segments were uniformly negative. U.S. high-yield bonds maintained their lead with a small loss, followed closely by U.S. asset-backed securities. U.S. Treasury Inflation-Protected Securities (TIPS) and mortgage-backed securities fared worse, but were still better off than a majority of the overall fixed-income market. U.S. Treasurys, U.S. investment-grade corporate fixed income, and global non-government debt performed in-line with each other, producing middling losses, while foreign-currency-denominated (external) emerging-market debt fell somewhat more steeply. Local-currency denominated emerging-market debt had the worst overall performance, followed at a distance by global sovereign securities.

Global equity markets advanced in November, as reflected by the MSCI AC World Index (Net), led again by the financial sector. Cyclicals performed well, with energy and industrials delivering significant gains, and materials and consumer discretionary also positive. Defensive sectors lagged, especially utilities and consumer staples, while telecommunications was down as well. Information technology and healthcare were also negative. Greece had the best country-level performance by a significant margin, followed by Russia, the U.S. and Peru. Canada, Singapore and Ireland also outperformed. Egypt had deep losses, followed at a distance by Turkey, Mexico and Indonesia. Brazil, the Philippines and the Czech Republic also had double-digit losses.

Index Data (November 2016)

- The MSCI AC World Index (Net), used to gauge global equity performance, advanced by 0.76%.
- The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, fell by 3.97%.
- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index that is also known as the “fear index”, decreased in the month, moving from 17.06 to 13.33.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, rose from $46.86 a barrel at the end of October to $49.44 on the last day in November.
- The U.S. dollar weakened relative to sterling, but strengthened against the euro and yen, ending November at $1.25 versus sterling, $1.06 against the euro and at 114 yen.

SEI’s View

The unanticipated outcome of the U.S. presidential election will have an impact on the economy and financial markets in the months and years ahead. Yet, we firmly believe that it would be a mistake to base even a short-term investment strategy on the results; this would require accurate predictions on the policies proposed by the new president, whether they become laws, and how they would impact the economy and financial markets.

At a high level, however, campaign promises provide some assurance that we can expect more fiscal stimulus, tax relief, deregulation and less free trade, and as a result, more inflation, interest-rate hikes from the Fed and a stronger dollar. These policies should help the U.S. economy at the expense of global trade. This would likely keep the Fed on its toes and could result in a more consistent rate-hike cycle; but too much tightening too fast could cause a shock. Still, higher rates indicate improved sentiment and should not hinder growth. We actually think the bull market could accelerate through 2017, with more attractively-valued cyclical and growth sectors leading the way. Corporate earnings, especially in energy, should begin to look better on a year-over-year basis when the first quarter of 2016 rolls off.

There are many things over which investors can lose sleep, but our over-arching investment stance remains unchanged. As long as central banks pursue aggressively easy policies in a world mostly characterised by slow economic growth (not recession) and mild inflation pressures, any pullback in the price of riskier assets should be limited.

One reason for maintaining this point of view is our belief that the U.S. economy is on fairly solid ground. It’s true that growth in overall business activity continues to disappoint, but household finances are in good shape as a result of expanding employment and incomes as well as the bull market in stocks and home values. There is little reason to expect a serious slowing in consumer spending.

[1] in USD, Global Bonds = Bloomberg Barclays Global Aggregate Bond Index, U.S. High Yield = BofA Merrill Lynch U.S. High Yield Master II Constrained, Global Sovereign Securities = Bloomberg Barclays Global Treasury Index, Global non-Government Debt = Bloomberg Barclays Global non-Treasury Index, Emerging Markets Debt (local currency) = JP Morgan GBI EM Global Diversified, Emerging Markets Debt (external currency) = J.P. Morgan EMBI Global Diversified, U.S. Mortgage-Backed Securities = Bloomberg Barclays U.S. Mortgage Backed Securities Index, U.S. Asset-Backed Securities = Bloomberg Barclays US Asset-Backed Security Index, U.S. TIPS = Bloomberg Barclays 1-10 Year U.S. TIPS Index, U.S. Investment-Grade Corporate = Bloomberg Barclays Investment Grade U.S. Corporate.

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Our main concern for the U.S. is weakness in business investment, which has negative implications for productivity. Slowing labour productivity growth and an acceleration in labour compensation growth is a bad combination. Since companies have been unable to raise prices sufficiently, the downward pressure on profit margins appears chronic. As this pressure intensifies, we expect companies will become more aggressive in their attempts to push through price increases.

This uptick in inflation, combined with the tightening labour market and steady pace of economic growth, seems to have tipped the balance in favour of a hike in the federal funds rate, probably in December. Fed policymakers have conceded that interest-rate normalisation will take years to accomplish, leaving little room to cut rates aggressively in the event of a recession. One result is that risk assets should continue to be well supported, and although equity valuations remain elevated, they still appear reasonable relative to those of high-quality bonds.

Treasury bond yields spiked higher following the election, and they could continue to rise. Historically, yields in the range of 4% to 5% have had a negative impact on growth. That number could be lower in our current environment, but in mid-November, yields for 10-and 30-year Treasury bonds were roughly 2.25% and 3%, respectively — a long way from being problematic. Nevertheless, Treasury yields have fully reversed their declines from earlier in the year, and are now roughly back to where they started. While we have seen some dramatic moves in rates this year, these higher rates are an indication of an improved outlook for economic growth.

With regard to the U.K., many observers have been surprised by the resiliency of its economy, although it is way too soon to sound the all-clear. The BOE has cut its base rate to the lowest level in the multi-century history of the central bank, and restarted its quantitative-easing programme and previously successful funding-for-lending scheme. On the fiscal policy side, the new Chancellor of the Exchequer has introduced a new budget that delays his predecessor's plans of achieving a budgetary surplus in order to provide some breathing room. In all, U.K. economic policy has shifted toward easing before the negative effects of Brexit can be felt. However, while no one knows what a final Brexit agreement will look like, we suspect it will be nowhere near the position being pushed forward by various U.K. leaders. Given this uncertainty, we think investment is likely to slow in the months ahead.

Eurozone exports and imports are in decline. Household spending is growing faster than other areas of the economy, as is the case in the U.S. and the U.K., but Europe's consumer rebound remains considerably less robust in comparison with these two countries. Although the labour market has certainly improved over the past three years, the country-by-country levels remain wildly disparate. This is especially so for the youth unemployment rate.

Italian Prime Minister Matteo Renzi became the latest casualty of the ballot box, tendering his resignation as promised after a referendum on constitutional reform went against him on 4 December. Markets shrugged off the development, although any gains in a new government by the Five-Star Movement, currently the most formidable Italian opposition party, could reverberate beyond Italy's borders given the party's anti-establishment euro-sceptic platform.

Our inclination is to favour equities and higher-yielding debt securities at the expense of developed-economy sovereign bonds that have extremely low or negative yields. Within equities, we prefer value and aggressive-growth characteristics over stability. In bonds, we favour securitised credit, bank loans and other credit-related trades.

Index Definitions

Bloomberg Barclays Global Aggregate Bond Index is an unmanaged market-capitalization-weighted benchmark that tracks the performance of investment-grade fixed- income securities denominated in 13 currencies. The index reflects reinvestment of all distributions and changes in market prices.

Bank of America Merrill Lynch U.S. High Yield Master II Constrained Index is a market-value weighted index of all domestic and Yankee (foreign U.S. dollar-denominated) high-yield bonds, including deferred interest bonds and payment-in-kind securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3 (the minimum threshold for investment-grade bonds) but are not in default. The Index limits any individual issuer to a maximum of 2% benchmark exposure.

Bloomberg Barclays Global Treasury Index tracks local currency denominated government debt of investment grade countries. The index represents the Treasury sector of the Bloomberg Barclays Global Aggregate Bond Index.

Bloomberg Barclays Global non-Treasury Index tracks local currency denominated non-government investment grade debt. The index represents the non-Treasury sector of the Bloomberg Barclays Global Aggregate Bond Index.

J.P. Morgan GBI-EM Global Diversified Index tracks the performance of debt instruments issued in domestic currencies by emerging market governments.

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J.P. Morgan EMBI Global Diversified Index tracks the performance of external debt instruments (including U.S.-dollar-denominated and other external-currency-denominated Brady bonds, loans, Eurobonds and local market instruments) in the emerging markets.

Bloomberg Barclays U.S. Mortgage Backed Securities Index measures the performance of U.S. investment-grade fixed-rate mortgage-backed securities.

Bloomberg Barclays U.S. Asset-Backed Security Index measures the performance of U.S. investment grade fixed-rate asset-backed securities.

Bloomberg Barclays 1-10 Year US TIPS Index measures the performance of inflation-protected public obligations of the U.S. Treasury that have a remaining maturity of one to ten years.

Bloomberg Barclays Investment Grade U.S. Corporate Index is an unmanaged index composed of U.S. investment-grade corporate bonds.

Glossary of Financial Terms

- Asset-backed securities: Asset-backed securities are a type of securitised debt that are backed by loans, leases or credit card debt, but not mortgages. Securitised debt consists of a portfolio of assets, such as mortgages or bank loans, which have been grouped together and repackaged as individual securities.
- Bull: Bullish refers to a positive view on the markets whereby investors are anticipating economic and market growth.
- Federal funds rate: The Federal funds rate is the interest rate at which a depository institution lends immediately available funds (balances at the Federal Reserve) to another depository institution overnight in the U.S.
- Cyclical: Cyclical sectors or stocks are those whose performance is closely tied to the economic environment and business cycle. Managers with a pro-cyclical market view tend to favour stocks that are more sensitive to movements in the broad market and therefore tend to have more volatile performance.
- High-yield debt: High-yield debt is rated below investment grade and is considered to be riskier.
- Mortgage-backed securities: Mortgage-backed securities are made up of multiple mortgages packaged together into single securities. These can be comprised of commercial or residential mortgages. Agency means that the debt is guaranteed by a government-sponsored entity, while non-agency means that it is not.
- Treasury Inflation-Protected Securities: Treasury Inflation-Protected Securities are U.S. Treasury securities issued at a fixed rate of interest but with principal adjusted every six months based on changes in the consumer price index.

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