Monthly Market Commentary

A Summer Holiday for Markets

August 2016

SEI New ways. New answers.®

- Markets in August were subdued, with a partial rebound in energy prices and mixed fixed-income performance.
- Risk appetite and renewed U.S. dollar strength was a key driver of fixed-income returns, which were led by U.S. high-yield bonds and external (foreign-currency denominated) emerging-market debt.
- We remain optimistic and U.S. risk assets look better than most. Defensive equity sectors still appear expensive, as do government fixed-income securities.

Economic Backdrop

Equity markets took a holiday in August. Low volatility and reduced trading prevailed as wary investors sought further clarity on the impact of the Brexit vote while also trying to predict central banks' next steps. Oil prices surged mid-month, then partially retreated, on the hopes that an early-September meeting between major oil producers Russia and Saudi Arabia would result in an agreement to freeze production. Fixed-income markets were mixed.

The Federal Reserve (Fed) hinted at its annual August conference that U.S. economic conditions may finally be stable enough to support another interest-rate increase before year end due to consistently solid labour-market performance and a firming outlook for inflation expectations; although a tepid August jobs report makes a September rate hike unlikely. Meanwhile, the Bank of England (BOE) undertook expansive monetary stimulus, pulling its benchmark interest rate down to the lowest in its 322-year history while simultaneously reinstituting a bond-buying programme in an effort to cushion its economy from Brexit vote aftershocks. The European Central Bank (ECB)'s July meeting minutes acknowledged new headwinds following the Brexit referendum and hinted that further stimulus might be necessary to stabilise the region's economy. The Bank of Japan (BOJ) — which doubled its exchange-traded-fund purchase programme in late July in a moderate easing effort — meets next month and is expected to take further action as it continues its struggle against deflation.

Reactions to the Brexit vote varied among U.K. businesses and consumers, but the news was mostly an improvement. Following a dismal July, manufacturing leapt into expansion territory in August by its largest increase in twenty-five years. Enthusiastic U.K. consumers largely shrugged off the Leave vote: economic growth climbed by 0.6% in the second quarter and 2.2% in the year ending 30 June due to record-breaking household spending. Retail sales came roaring back in July, led by non-food, textiles, clothing and footwear stores. The housing market continued its winning streak in August, as home prices rose to their highest level since March. On the minus side: activity in the services sector fell at its fastest pace in seven years in July, moving into its first contraction since 2012; new business inquiries and sentiment in the sector (which accounts for almost 80% of the British economy) declined sharply. Consumer prices also tumbled in July due to lagging prices in recreation and culture services.

Post-Brexit economic data in the eurozone were also mixed. August brought slow-but-steady expansion to the region; service providers saw their best growth in new orders in four months; although new orders in manufacturing declined. Producer prices jumped in July at their fastest rate since August 2012 and lending also gained 1.9% in July. However, economic sentiment deteriorated more than expected in August; confidence in services and retail trade also dropped, suggesting that Brexit could reverse the modest economic recovery underway in the region. Inflation edged up to 0.2% year over year in August, unchanged from July and still far short of the ECB's desired 2% rate; it has not breached 0.3% since March 2014. Second-quarter economic growth was diluted following the referendum, as expected. The four largest countries in the region (France, Germany, Spain and Italy) all experienced contraction; while Greece and Latvia showed improvement.

A respectable 151,000 new jobs were created in the U.S. in August. Unemployment remained at 4.9% — a level considered full employment — and wage growth exceeded inflation. While August's jobs report was fair, gains for the month were far less impressive than the 275,000 added in July, and may not be enough to persuade Fed officials to raise interest rates at their meeting in September. Manufacturing contracted in August for the first time in six months as new orders backslid. Consumers continued to drive the economy: consumer spending expanded as a result of robust vehicle sales and spending on services in July. Personal income also rose in July due to a boost in wages and salaries.

© 2016 SEI

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

Market Impact[1]

Global fixed-income markets declined in aggregate during August, and U.S. high-yield bonds enjoyed another month as the strongest performing segment, followed by foreign-currency-denominated (external) emerging-market debt. U.S. dollar-hedged (which seeks to reduce U.S. dollar-related volatility) global non-government debt was modestly positive, as were U.S. mortgage- and asset-backed securities. Local-currency denominated emerging-market debt was marginally positive, and U.S. investment-grade corporate fixed income also advanced slightly. Dollar-hedged global sovereign securities declined during the month, and both U.S. Treasurys and Treasury Inflation-Protected Securities (TIPS) dipped. Unhedged global sovereign debt was the worst performer in August.

Global equity markets, as reflected by the MSCI AC World Index (Net), advanced modestly during the month. Colombia — last month's poorest performer — rotated into the lead, followed by China, Ireland and Qatar. Thailand, Korea and the Netherlands had strong returns, as did Hungary and Russia. The Czech Republic delivered the poorest performance, while South Africa, Denmark, Peru and Chile were also deeply negative. Global sector performance was led by financials, followed closely by information technology; industrials also did well, and energy turned in a positive performance. Traditional defensive sectors struggled, with utilities and healthcare declining sharply, while telecommunications and the consumer sectors were also down for the month.

Index Data (August 2016)

- The MSCI AC World Index (Net), used to gauge global equity performance, advanced by 0.34%.
- The Barclays Global Aggregate Index, which represents global bond markets, declined by 0.49%.
- 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", increased in the month, moving from 11.87 to 13.42.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, jumped from $41.60 a barrel at the end of July to $44.70 on the last day in August, setting an intra-month high of $48.52 on 19 August.
- The U.S. dollar strengthened relative to sterling, the euro and yen, and ended August at $1.31 versus sterling, $1.11 against the euro and at 103.4 yen.

SEI's View

Angst is the one thing everyone seems to share in common across the world. The U.K.'s vote to leave the EU is a major political and economic event that will likely weigh on international financial markets, not just for weeks and months, but perhaps for years. The leap into the unknown will likely dampen economic growth as business spending gets frozen until some clarity re-emerges on the country's trading relationships. Sterling's plunge immediately following the Leave vote, however, should provide a much-needed offset to the mostly negative impact of all the uncertainty, as U.K. exporters find themselves in a more competitive position.

The ability of the equity market to bounce back from the immediate shock is heartening, but it is hard to draw firm conclusions on how disruptive Brexit will be on future EU and eurozone economic activity. The fragility of the recovery going into this crisis is a matter of deep concern. The fact that bond yields did not bounce higher even as stock prices rallied post-Brexit is a divergence worth noting.

In our opinion, the U.S. remains the cleanest shirt in the laundry bag, staying resilient despite numerous shocks over the past seven years, including the period immediately following the Brexit vote. The first hints of wage pressure are coming through, with a moderate acceleration in wages and total labour compensation apparent on a year-over-year basis. As corporate margins get squeezed by the pick-up in labour costs, the pressure to raise prices will likely intensify.

This puts the Federal Reserve in something of a quandary, since the Brexit shock has seemingly upended any possibility of a near-term rise in the federal funds rate. Market-implied expectations for the next policy-rate move suggest December 2016 at the earliest. Yet, we admit to a growing uneasiness that the central bank may be a falling behind the inflation curve.

[1] in USD, Global Bonds = Barclays Global Aggregate Bond Index, U.S. High Yield = BofA Merrill Lynch U.S. HY Master II Constrained, Global Sovereign Securities = Barclays Global Treasury Index, Global non-Government Debt = 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 = Barclays U.S. Mortgage Backed Securities Index, Asset-Backed Securities = Barclays US Asset-Backed Security Index, U.S. TIPS = Barclays 1-10 Year U.S. TIPS Index, U.S. Investment-Grade Corporate = Barclays Investment Grade U.S. Corporate.

© 2016 SEI

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

We understand that the still-soggy global economy and the shock delivered by the U.K. vote argue for a very cautious process of interest-rate normalization. But if the upward trend in labour costs is sustained, a more aggressive response by the U.S. central bank eventually will be justified.

In the months immediately ahead, investors' attention will be focused on the U.S. presidential election. We want to make one simple point: markets hate the unknown. For good or ill, former Secretary of State Clinton is the familiar, status quo candidate. Donald Trump, on the other hand, promises to shake things up. In a year where voter dissatisfaction is exceptionally strong in the U.S., we would not hazard a guess as to the outcome this early in the process. Investors need to be prepared for a bit of volatility in the months ahead, since the uncertainty level will likely remain elevated between now and the election. For now, we lean toward the optimistic side, mainly because U.S. economic and financial fundamentals appear relatively healthy.

One of the more surprising market responses to the U.K. Brexit vote is the sharp appreciation of the Japanese yen. This is the last thing that the country needs, since an ultra-strong currency exacerbates downward pressure on inflation. Corporate earnings have begun to roll over in response to the currency's appreciation. As Japanese yields sink further into negative territory across the curve, we wonder what kind of rabbit the BOJ can pull out of its hat, since the most recent interest-rate moves have failed to weaken the currency or boost the economy.

Investors' fears earlier this year of an imminent Chinese debt and currency meltdown have receded. China's economy mostly appears to treading water, much like the rest of the world. The government continues to use the old and familiar economic playbook: encourage growth fuelled by additional debt, prop up state-owned enterprises and allow its currency to fall. Economic and financial reforms are proceeding, but at an erratic pace. Chinese equities have not shown much spark, however, despite the "risk-on" environment for emerging-market assets that began in late January.

Globally, the points of general consistency in our investment outlook and positioning are that the stability alpha source and momentum appear expensive within equities, and that our fixed-income managers generally favour credit at the expense of duration.

© 2016 SEI

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

Index Definitions

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.
Barclays Global Treasury Index tracks local currency denominated government debt of investment grade countries. The index represents the Treasury sector of the Barclays Global Aggregate Bond Index.
Barclays Global non-Treasury Index tracks local currency denominated non-government investment grade debt. The index represents the non-Treasury sector of the 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.
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.
Barclays U.S. Mortgage Backed Securities Index measures the performance of U.S. investment-grade fixed-rate mortgage-backed securities.
Barclays U.S. Asset-Backed Security Index measures the performance of U.S. investment grade fixed-rate asset-backed securities.
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.
Barclays Investment Grade U.S. Corporate Index is an unmanaged index composed of U.S. investment-grade corporate bonds.

Glossary of Financial Terms

- Alpha source: Alpha source is a term used by SEI as part of our internal classification system to categorise and evaluate investment managers in order to build diversified fund portfolios. An alpha source is the investment approach taken by an active investment manager in an effort to generate excess returns. Another way to define an alpha source is that it is the inefficiency that an active investment manager seeks to exploit in order to add value.
- 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.
- Bullish: Bullish refers to a positive view on the markets whereby investors are anticipating economic and market growth.
- Duration: Duration is a measure of risk in bond investing and indicates how price-sensitive a bond is to changes in interest rates. A long (overweight) duration stance indicates the portfolio duration is higher than that of the benchmark whereas a short (underweight) duration stance indicates a lower duration. Duration is measured in years and securities with longer durations are more sensitive to interest-rate changes.
- 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.
- Fundamentals: Fundamentals refers to data that can be used to assess a country or company's financial health such as amount of debt, level of profitability, cash-flow, inventory size etc.
- 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.

© 2016 SEI

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

Important Information:

Past performance is not a guarantee of future performance.

Investments in SEI Funds are generally medium to long term investments. The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested. Additionally, this investment may not be suitable for everyone. If you should have any doubt whether it is suitable for you, you should obtain expert advice.

No offer of any security is made hereby. Recipients of this information who intend to apply for shares in any SEI Fund are reminded that any such application may be made solely on the basis of the information contained in the Prospectus. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any stock in particular, nor should it be construed as a recommendation to purchase or sell a security, including futures contracts.

In addition to the normal risks associated with equity investing, international investments may involve risk of capital loss from unfavourable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Bonds and bond funds are subject to interest rate risk and will decline in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments. Narrowly focused investments and smaller companies typically exhibit higher volatility. SEI Funds may use derivative instruments such as futures, forwards, options, swaps, contracts for differences, credit derivatives, caps, floors and currency forward contracts. These instruments may be used for hedging purposes and/or investment purposes.

While considerable care has been taken to ensure the information contained within this document is accurate and up-to-date, no warranty is given as to the accuracy or completeness of any information and no liability is accepted for any errors or omissions in such information or any action taken on the basis of this information.

This information is issued by SEI Investments (Europe) Limited, 1st Floor, Alphabeta, 14-18 Finsbury Square, London EC2A 1BR which is authorised and regulated by the Financial Conduct Authority. Please refer to our latest Full Prospectus (which includes information in relation to the use of derivatives and the risks associated with the use of derivative instruments), Key Investor Information Documents and latest Annual or Semi-Annual Reports for more information on our funds. This information can be obtained by contacting your Financial Advisor or using the contact details shown above.

SEI sources data directly from Factset, Lipper, and BlackRock.

© 2016 SEI