Quarterly Market Commentary: Rally on Central Bank Actions (and Inaction)

Third Quarter 2016

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- The quarter began with a post-Brexit-vote recovery rally across most stock markets, levelling off by mid-quarter before an early September selloff. Supportive central-bank decisions propelled a rebound, which held through quarter end.
- Fixed-income markets had another strong quarter, led again by U.S. high yield bonds and emerging-market debt.
- Within equities, we prefer value and aggressive-growth characteristics over stability. In bonds, we favour securitised credit, bank loans and other credit-related areas at the expense of low-yielding developed-economy sovereign bonds.

Economic Backdrop

The third quarter began with a boost as the post-Brexit-vote recovery rally continued in force across most stock markets around the globe. The trend levelled off by mid-quarter, with the S&P 500 index, representing U.S. large-company stocks, hitting an all-time high on 15 August, before an early September selloff. The U.S. Federal Reserve's (Fed) decision to hold back from increasing rates was well-received, as stocks recovered and moved sideways through the end of the quarter. U.S. Treasury yields increased during the quarter (yields move inversely to prices), while U.K. gilt yields generally declined. Short- and intermediate-term eurozone government bond yields declined, while long-term yields increased. Oil prices hit their lowest levels in early August since the depths of the first-quarter selloff, before mounting a choppy recovery that was boosted at the end of the quarter by a tentative Organization of the Petroleum Exporting Countries (OPEC) production-cut agreement.

The European Central Bank (ECB) joined the Fed in holding firm during the quarter, while the Bank of England (BOE) delivered a rate cut coupled with asset-purchase and term-funding programmes at its early-August meeting. The Bank of Japan (BOJ) announced a novel policy change in late September: keeping the 10-year Japanese government bond yield at 0% with a commitment to alter its bond-buying pace as needed to meet this goal. The BOJ also expressed its intention not only to achieve, but temporarily exceed, its target inflation level (currently 2%) to increase inflation expectations.

U.K. manufacturing activity began the quarter in contraction, only to bounce back to healthy growth levels by September. Construction followed a similar trajectory, albeit starting from further behind and ending up with softer growth. Services growth mostly held firm in September, after delivering a historically massive one-month improvement in August (from July's contraction). Retail sales volumes weakened in September following a strong rebound from July's post-Brexit-vote plummet. The employment situation treaded water, with claimant count unemployment steady thru June, July and August. Consumer prices bounced higher in August, but year-over-year price growth remained far below its long-term average. Producer input prices turned positive year over year during the quarter for the first time since late 2013, and ramped up in earnest through August. Second-quarter economic growth expanded in its final estimate, reaching 0.7% for the period.

Eurozone consumer price growth continued to increase during September on a year-over-year basis, with price pressures rising in five of the past six months. Producer price changes, however, plummeted back into negative territory in August, and remained chronically underwater year over year. Manufacturing activity treaded water in low-growth territory throughout the quarter; September services activity showed growth had settled a bit, trailing the pace of the manufacturing expansion. The eurozone unemployment rate remained at 10.1% in August; youth unemployment, which remains elevated, was down 1.6% from a year earlier. Economic sentiment improved in September to its best reading since January, after tumbling in August. Confidence in the industrial sector showed the most marked improvement, but consumer sentiment also rose. The latest second-quarter gross domestic product (GDP) reading depicted 0.3% growth, half the first quarter's pace. The four largest countries in the region (France, Germany, Spain and Italy) all had declining growth; although Greece and Latvia showed improvement.

The U.S. labour-market continued to strengthen during the quarter. Jobless claims tied multi-decade record lows in September, although August's payrolls report depicted a weakening expansion following June and July's impressive showings. Personal income growth fell more closely in line with its long-term average in August after an impressive July. Core personal consumption expenditures — the Fed's preferred inflation measure — edged upward to 1.7% year over year in August, nearer to the Fed's 2% target. U.S. housing-market confidence reached its highest level in a year during September, and future sales expectations hit an 11-year high. The U.S. economy grew at an annualized 1.4% pace in the second quarter, slightly faster than initially estimated. Overall, however, expansion softened for the first six months of the year relative to the first half of 2015.

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

Market Impact[1]

Fixed-income markets had another strong quarter, led again by riskier market segments. U.S. high-yield bonds delivered the strongest performance, followed by foreign-currency-denominated (external) emerging-market debt. Local-currency-denominated emerging-market debt also performed very well during the quarter, and had September's best returns, while investment-grade U.S. corporate bonds also had an impressive quarter. Global non-government debt delivered strong performance, while U.S. mortgage-backed and Treasury Inflation-Protected securities also performed well. Global sovereign securities and U.S. asset-backed securities had modest positive returns, while U.S. Treasurys declined.

Global equity markets, as reflected by the components of the MSCI AC World Index (Net), advanced during the third quarter. Egypt had the strongest country-level returns by a considerable margin, followed by Austria. The Asia-Pacific region also had very impressive performance, led by China, New Zealand, Hong Kong and Taiwan. Brazil, Korea, Hungary and Germany also delivered double-digit returns. Denmark had the deepest losses, followed by Philippines and Turkey. Mexico, Israel, Chile and Malaysia had smaller losses, while the Czech Republic and Singapore were marginally negative. Global sectors were mostly positive, led by information technology at a distance. Materials, financials, consumer discretionary and industrials also delivered very strong quarterly performance. Traditional defensive sectors lagged: utilities declined by the most, followed telecommunications, while consumer staples was only modestly negative.

Index Data (Third Quarter 2016)

- The MSCI AC World Index (Net), used to gauge global equity performance, rose by 5.30%.
- The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, advanced by 0.82%.
- 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 quarter as a whole, moving from 15.63 to 13.29, peaking at 18.14 on 14 September.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, moved from $48.33 a barrel on the last day in June to $48.24 at the end of September, falling as low as $39.51 on 2 August.
- The U.S. dollar strengthened against sterling during the quarter, but weakened versus the euro and yen. The U.S. dollar ended September at $1.30 versus sterling, $1.12 against the euro, and at 101.3 yen.

SEI's View

There are many things over which investors can lose sleep: Brexit-related stresses, disenchantment with free trade, ineffective monetary policy, pressure on corporate profit margins, severe debt burdens, and intense political uncertainty. 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.

In general (and especially as it pertains to the U.S.), we continue to view equity-market corrections as buy-on-the-dip opportunities. 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, bonds and home values. There is little reason to expect a serious slowing in consumer spending.

We also expect the change in business inventories — the most volatile part of GDP, which has slowed in recent quarters — to rebound in the quarters ahead, supporting a reacceleration in overall U.S. GDP into the 2.5%-to-3.0% range.

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 slow-but-steady pace of economic growth, seems to have tipped the balance in favour of a hike in the federal funds rate, probably in December. At their latest meeting, Fed policymakers finally conceded that interest-rate normalisation will take years to accomplish, leaving little room to cut rates

[1] in USD, Global Bonds = Bloomberg Barclays Global Aggregate Bond Index, U.S. High Yield = BofA Merrill Lynch U.S. HY 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, 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.

aggressively in the event of a recession. Investors remain sceptical that the central bank will even achieve its stated objective of pushing its policy rate to the upside. As a result, risk assets should continue to be well supported. Although equity valuations remain elevated, they still appear reasonable relative to those of high-quality bonds.

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 picking a winner in November; 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.

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 pre-emptively 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 scrapped his predecessor's austerity plans and is expected to introduce a new budget that abandons any notion of achieving a budgetary surplus by the end of the current parliament. In all, U.K. economic policy has shifted dramatically toward easing well 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.

We're concerned that it's just a matter time before another crisis tests the cohesion of the eurozone. It's possible that the Italian constitutional referendum, to be held 4 December, could provoke such a crisis. If the vote goes against the government, Prime Minister Matteo Renzi may be forced to make good on his promise to hold elections. Unfortunately for him, polls show that the Italian electorate is in a cantankerous mood.

If the Five-Star Movement, currently the most formidable Italian opposition party, were to win power, the impact would be far more earth-shaking than the Syriza party's January 2015 victory in Greece. Italy's economy is some seven times greater than that of Greece, so one can only imagine how markets will react to the possibility of an Italian threat to leave the euro framework. ECB President Draghi knows he has a potential problem on his hands. He continues to reassure investors that the central bank has the will, the tools and the ability to improve the eurozone's fortunes.

The Japanese economy still lacks momentum despite fiscal stimulus packages, structural reforms and extremely aggressive monetary policy initiatives. Industrial output has trended lower over the past three years, hurt by the slowdown in global trade, and although the country's merchandise trade balance has turned positive, this is merely the result of imports falling faster than exports.

On the positive side, housing construction is running near a cyclical high. The unemployment rate, which is structurally much lower than in other developed countries, dipped to 3.1%. Nominal wages remain stuck near zero, however, and inflation expectations have been nearly impossible to nudge to the upside. Our Asia-focused portfolio managers are heartened by improvements in corporate governance and the use of capital. Additionally, the latest fiscal-policy initiative is a significant one, with new spending amounting to ¥7.5 trillion. In the current fiscal year, stimulus is expected to reach 4.5% of GDP.

We think China's economy will continue to reaccelerate in the near term. Although the country's growth rate remains below trend, we are beginning to see an improving trajectory following two and a half years of slowdown. The renminbi has depreciated steadily in the year to date, falling 7% against a basket of currencies and less than 3% against the U.S. dollar. While the depreciation of the renminbi has not reinvigorated exports, it appears to have stopped its two-year decline. Domestic economic growth in China has been relatively stable this year, with retail sales growing around 10% on a year-over-year basis and industrial output running at a 6% rate. Importantly, the country continues to evolve into a services-oriented economy, with that sector now accounting for more than half of GDP. Housing activity also has picked up. The question now becomes whether government economic policy flips back toward structural reform and economic rationalisation and away from stimulus, given that business activity looks to be in a less fragile state than a year ago.

Before the global financial crisis, the U.S. and China were the primary growth engines of the world. Those engines are sputtering when compared to their pre-crisis performance. We think it's possible that India eventually will become a third major engine of global growth. In the past year, its GDP growth was greater than China's. While its population is nearly as large, India is growing faster and is much younger. As India institutes economic, financial and legal reforms, it has the potential to grow rapidly for a long time.

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.

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 market: A bull market refers to a market environment In which prices are generally rising (or are expected to do so) and investor confidence is high.
- 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.
- 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.
- Quantitative easing: Quantitative easing refers to expansionary efforts by central banks to help increase the supply of money in the economy.
- Securitised credit: Securitised credit consists of a portfolio of assets, such as mortgages or bank loans, which have been grouped together and repackaged as individual securities.
- 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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