# Economic Overview
# Quarterly Investment Review

Third Quarter 2016

SEI New ways. New answers.®

# Point of View

Economic Outlook

# The Outlook: Markets Climb a Great Wall of Worry

## The good news

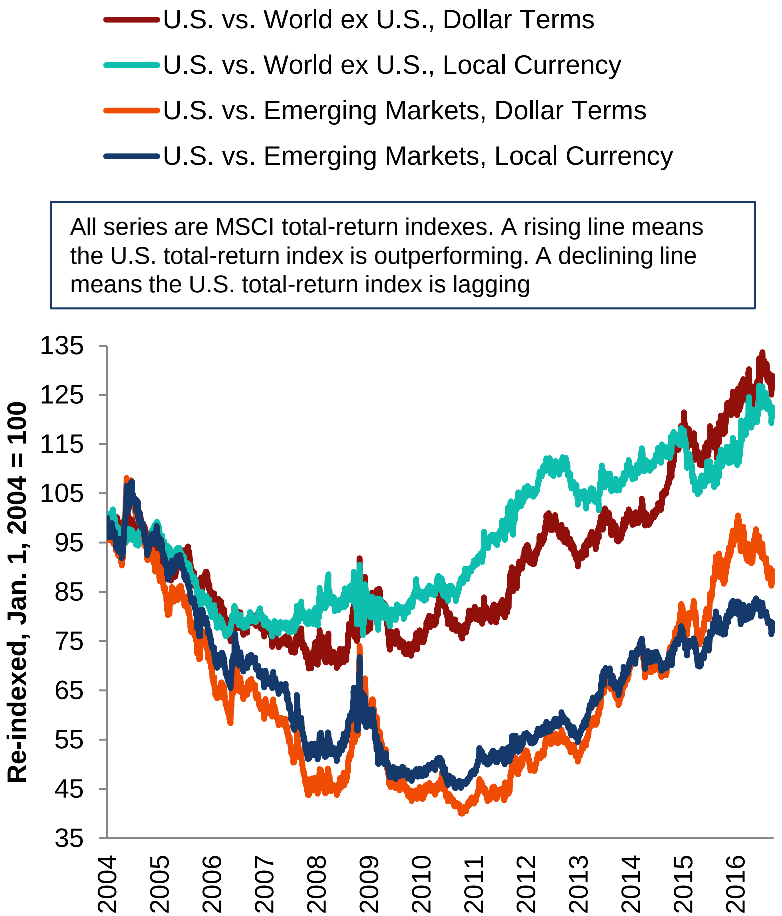
- Global economic growth remains mostly unimpressive, but aggressively easy central-bank monetary policy will likely be successful in extending the life of this expansion through 2017 and beyond.
- Risk assets remain in favour despite the prospect of the U.K. exiting the European Union, growing pressures on profit margins, severe sovereign- and corporate-debt problems in Europe, China and other countries, and general political uncertainty.
- Emerging markets are enjoying their best run since 2009 on reduced fears over China's debt, a stabilization of oil and other commodity prices and investor-friendly political and economic reforms in several countries including Brazil and India.
- Our portfolios generally prefer the equity of companies with value characteristics (such as low price-to-earnings and price-to-book ratios) versus low-growth, high-yielding sectors (such as utilities) and consistent growers (like consumer staples) at a time when value stocks are trading at deep discount to more stable stocks.

## The bad news

- Europe appears vulnerable to another crisis phase, with an Italian referendum in December that threatens the government's credibility, general elections in France and Germany in 2017, and Brexit negotiations beginning in earnest in April serving as possible catalysts.
- U.S. corporate profit margins have begun to narrow as labour costs rise and productivity sags, raising the prospect of further acceleration in domestic inflation.
- If history serves as a guide, the U.S. Presidential election could usher in a period of greater-than-average stock market moves, not just in the immediate aftermath of the vote but also over the following year.
- We view extraordinary monetary policy measures like negative interest rates and quantitative easing as increasingly ineffective tools that only serve to distort financial markets and may even be undermining the bank recovery in Europe and Japan.

# Flipping the Switch to "Risk On"

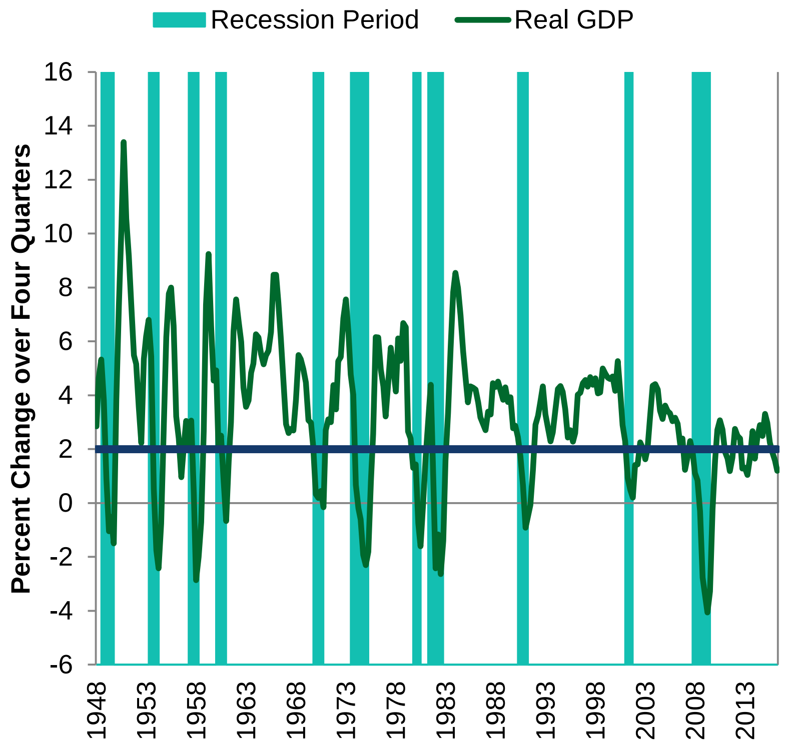
- The MSCI All-Country World ex USA Total Return Index posted positive returns in September in both U.S. dollar and local-currency terms.
- For the quarter, international equities performed exceptionally well, as post-Brexit-vote fears faded in Europe and emerging markets continued their rally.
- From a longer-term perspective, however, the U.S. has been the clear leader over the past five years.



Source: MSCI, SEI

# U.S. GDP stalling but not falling

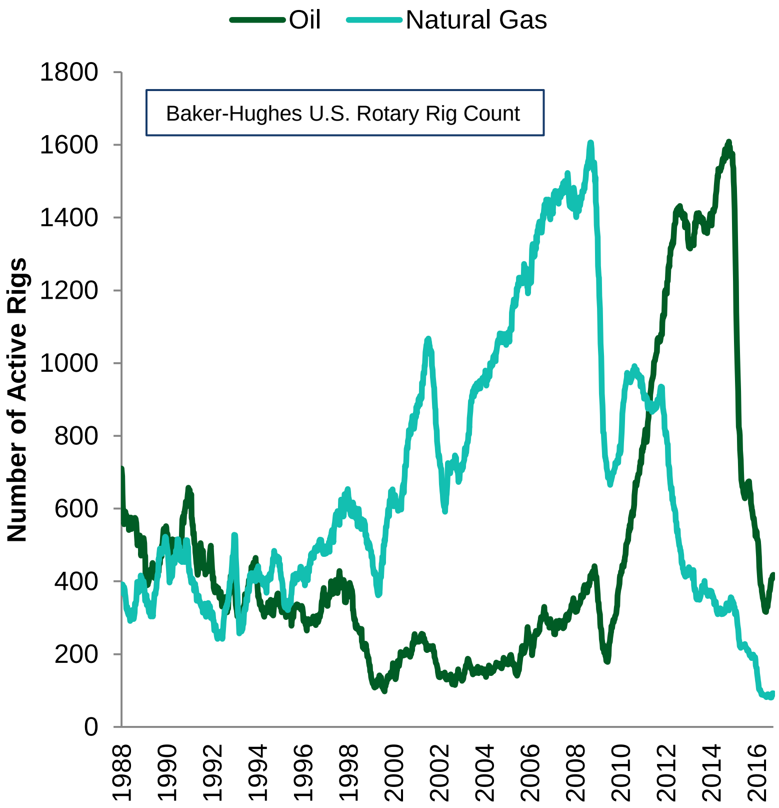
- On almost every occasion since 1950, when the four-quarter change in U.S. real GDP slid below 2%, economic growth would keep sagging and eventually fall into recession.
- The one exception prior to the current cycle was 1956.
- Since 2011, however, GDP growth has meandered around its 2% “stall speed” line persistently, dipping below that line three times.
- We believe that another reacceleration back above 2% growth is coming.
- Household finances are in good shape as a result of decent employment trends and the bull market in stocks, bonds and home values.
- There is little reason to expect a serious slowing in consumer spending.




**Source: Bureau of Economic Analysis, National Bureau for Economic Research, SEI**
*As of 30/06/2016*

# Not as rigged as it used to be

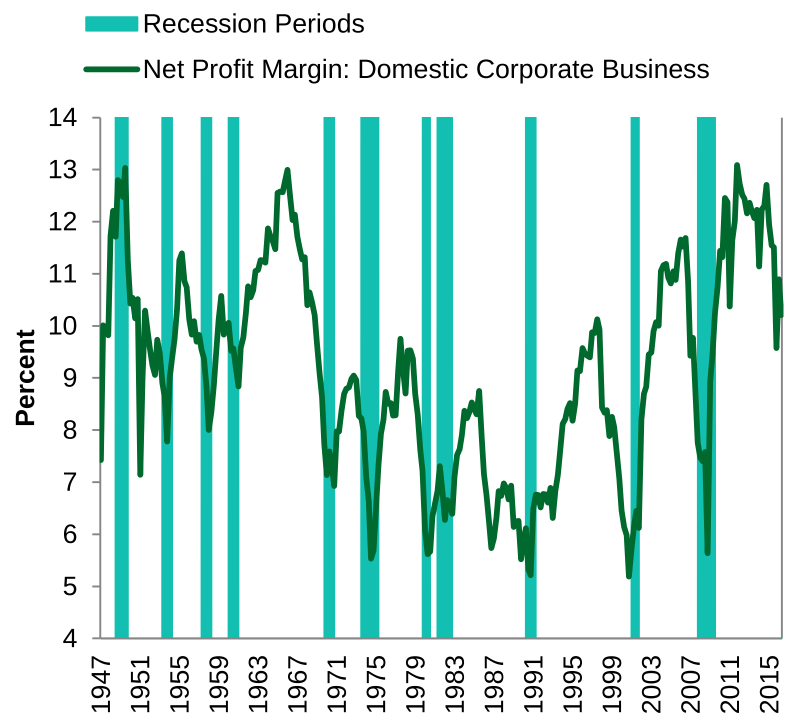
- Our main concern for the U.S. is weakness in business investment on equipment and structures.
- The decline in expenditures on pipelines and oil-related equipment has been especially severe since the fracking boom turned into a bust.
- Although much has been made of the turnaround in the rig count in recent months, the total number of oil rigs operating in the U.S. is still 75% off its October 2014 peak.




**Source: Baker Hughes, SEI**

# A marginal matter of great importance

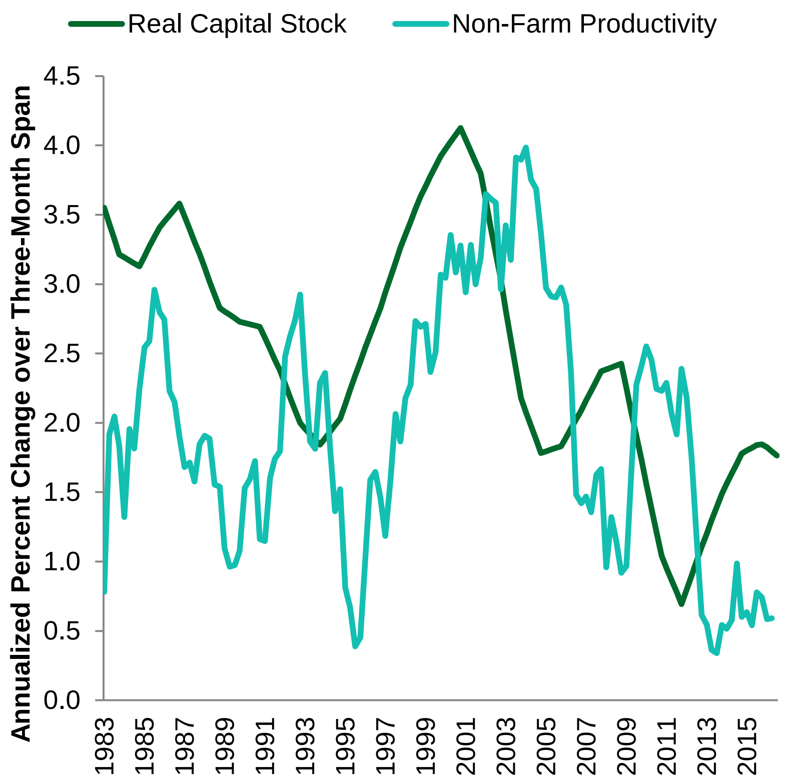
- The chart tracks the net profit margin of domestic corporate business in the U.S., as derived from the gross domestic product accounts.
- Although the cycle peak occurred back in 2011, the margin has stayed elevated until rather recently.
- The good news is that margins are still high relative to the historical record.
- The bad news is that the trend is downward, and margin deterioration usually precedes economic recessions.




**Source: Bureau of Economic Anaylsis, Economic Cycle Research Institute, Philosophical Economics, SEI**
*As of 30/06/2016*

# Taking the capital out of capitalism

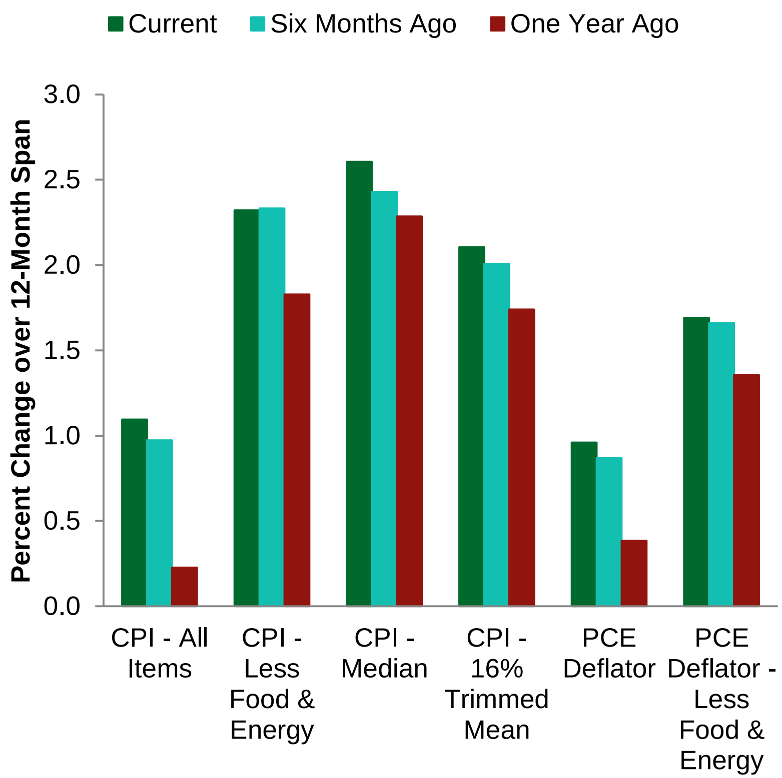
- The poor investment trend has depressed the growth of America's capital stock (plant and equipment), with negative implications for productivity.
- The extremely slow pace of productivity growth in recent years is becoming a major concern for economists. When output per hour fails to grow, living standards stagnate and inflation pressures can increase.
- It's possible that the slowdown in productivity has been exaggerated by measurement issues.
- Nonetheless, we would caution against complacency. The long-run connection between U.S. growth in the capital stock and productivity can be clearly seen in the chart.




**Source: Oxford Economics, U.S. Department of Labor, SEI**

# U.S. Inflation is inflating

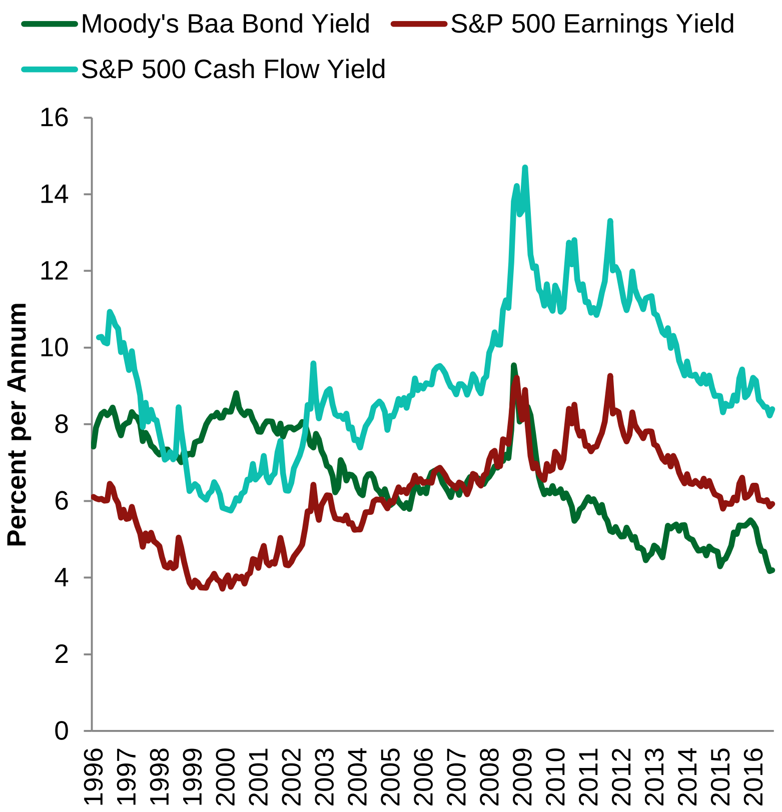
- Higher inflation, we believe, is almost certainly in America's future.
- The chart shows a few different measures of U.S. inflation.
- All of them have accelerated, at least modestly, versus their year-ago readings.
- Among the more widely followed inflation yardsticks, the core consumer price index (excluding food and energy) is up 2.3% versus the year-ago level, while the total consumer price index (CPI) is up 1.1% through August.




**Source: Federal Reserve System, U.S. Bureau of Economic Analysis, U.S. Department of Labor, SEI**
*As of 31/08/2016*

# Compared to bonds, U.S. stocks look cheap

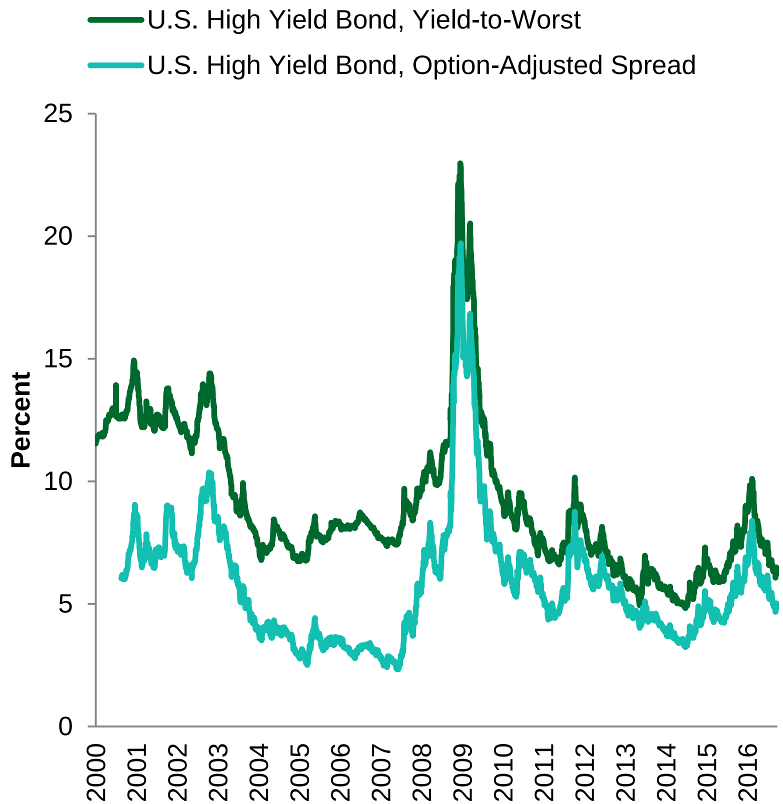
- The chart tracks the earnings yield (that is, the inverse of the price-to-earnings ratio) and the cash-flow yield on the S&P 500 Index.
- It compares those two measures against the yield on the Baa corporate bond.
- Although spreads have narrowed, they remain comfortably above the bond yield.



Source: Moody's, S&P, SEI

# The low down on high yield

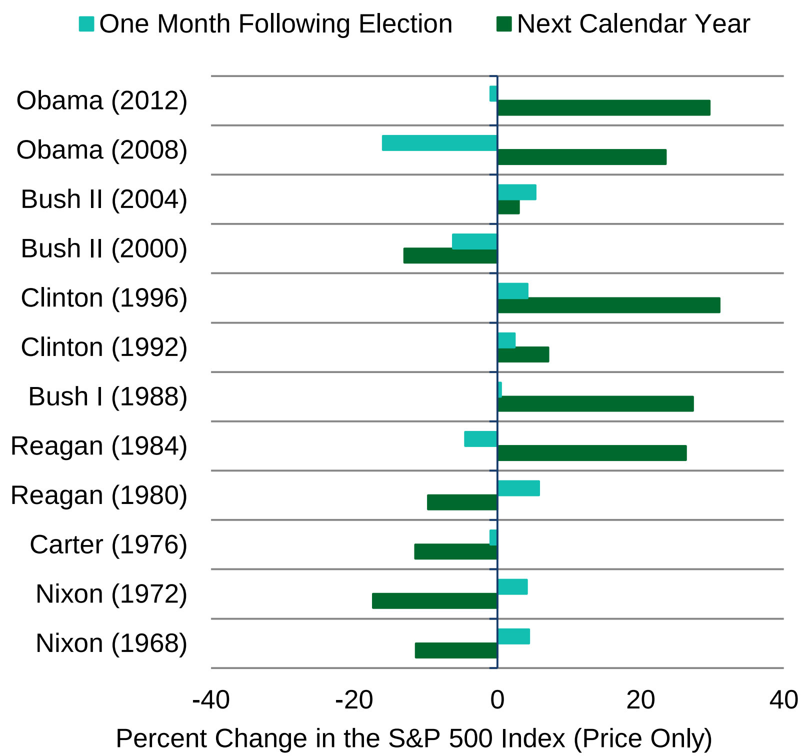
- In the U.S. corporate high-yield market, the outlook remains positive.
- Maturities through 2017 appear manageable, despite a rising trend in default rates.
- Yield-to-worst and options-adjusted spreads (as measured by Bloomberg Barclays) have narrowed sharply since mid-February, as the chart shows, reflecting the rebound in energy and other commodity-oriented companies' bonds.




**Source: Bloomberg Barclays, SEI**

# A random walk down Pennsylvania Avenue

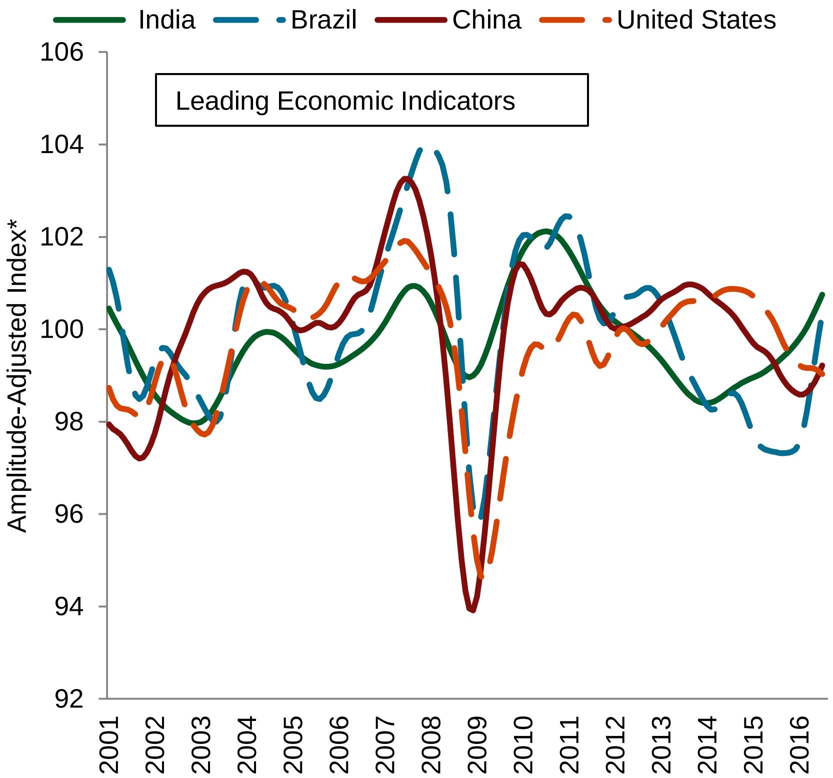
- The chart shows the S&P 500 Index's one-month and one-year returns following each of the last 12 presidential elections, starting with Richard Nixon's victory over Hubert Humphrey in 1968.
- Looking at the numbers, the only thing that can be said with any confidence is that markets have a tendency to be more volatile both immediately following the presidential election and over the following year.
- What cannot be said with any conviction is the direction or ultimate magnitude of the change**.**




**Source: Macro Risk Advisors, Ned Davis Research, Standard & Poor's, SEI**

# Following the leaders

- The chart compares the leading economic indicators of India, China, Brazil and the U.S.
- Notice that China's leading economic indicators figure is just starting to hook higher.
- India's leading indicators have been on the mend since the start of 2014; according to this metric, the Indian economy is now growing above trend.
- The recovery in Brazil is even more dramatic; although this mainly reflects the big rebound in its equity market.
- Gross domestic product and industrial output remain exceedingly depressed, yet there has been a modest lift off the low in the former.

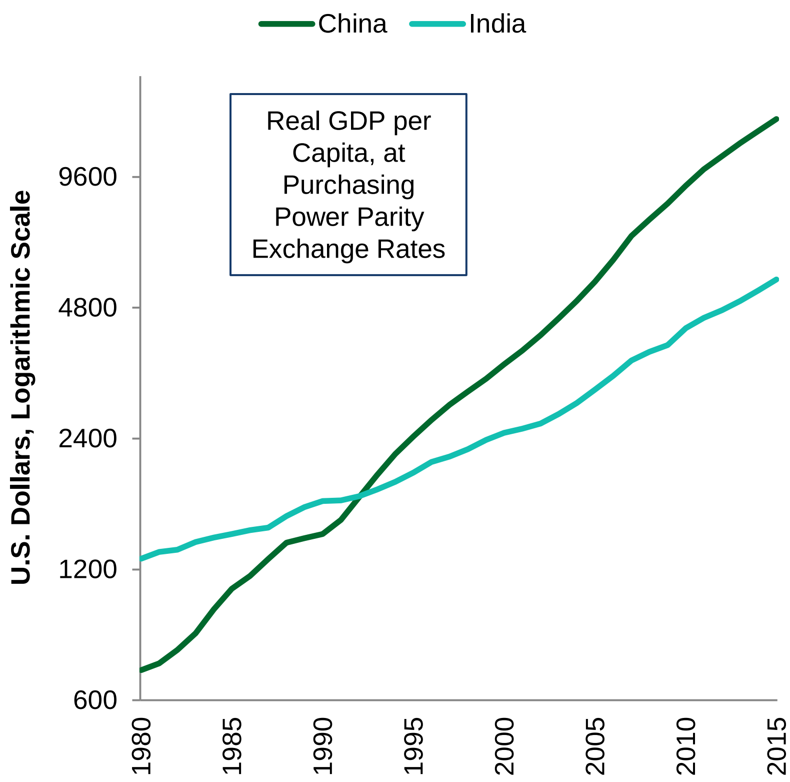



**Source: OECD, SEI**
*As of 31/08/2016*

*A reading above 100 that is rising predicts expansion, above 100 and falling a downturn, below 100 and falling a slowdown and below 100 and rising a recovery.

# India gets left behind

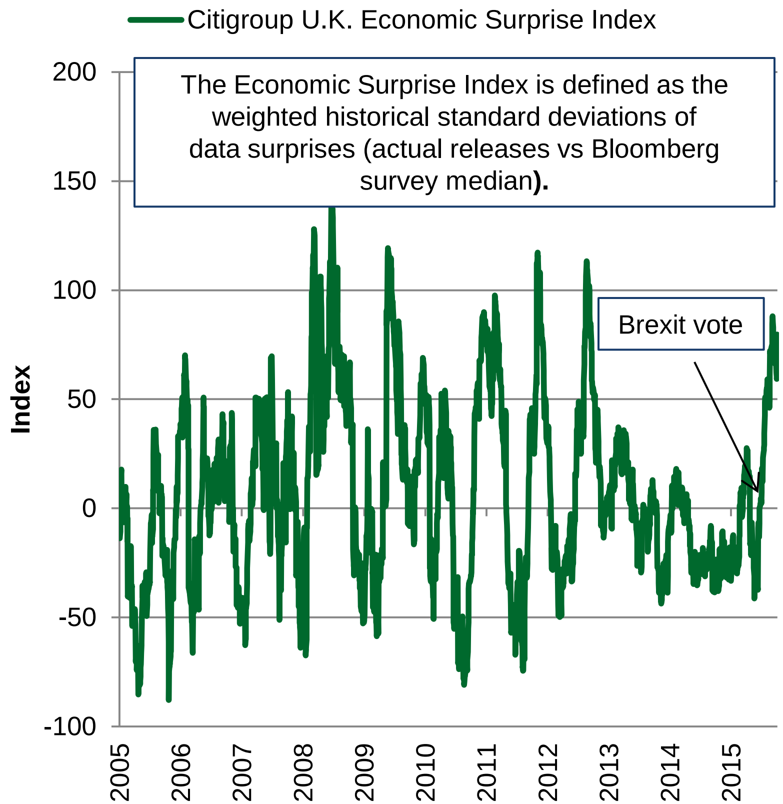
- The chart shows how gross domestic product (GDP) per capita in China has far outpaced that of India.
- We see little reason why India cannot enjoy a similar multiyear growth spurt, and begin to close that gap in the coming decades.
- After years of bickering, India's parliament finally passed a uniform goods-and-services tax that is expected to take effect as early as April 1, 2017.
- This is a major accomplishment that could accelerate GDP growth by over one percentage point per annum, owing to the streamlining of the tax code and the breaking down of barriers to trade that have inhibited the free flow of goods and services from one part of the country to another.




**Source: Oxford Economics, SEI**
*As of 31/12/2015*

# Surprise, surprise

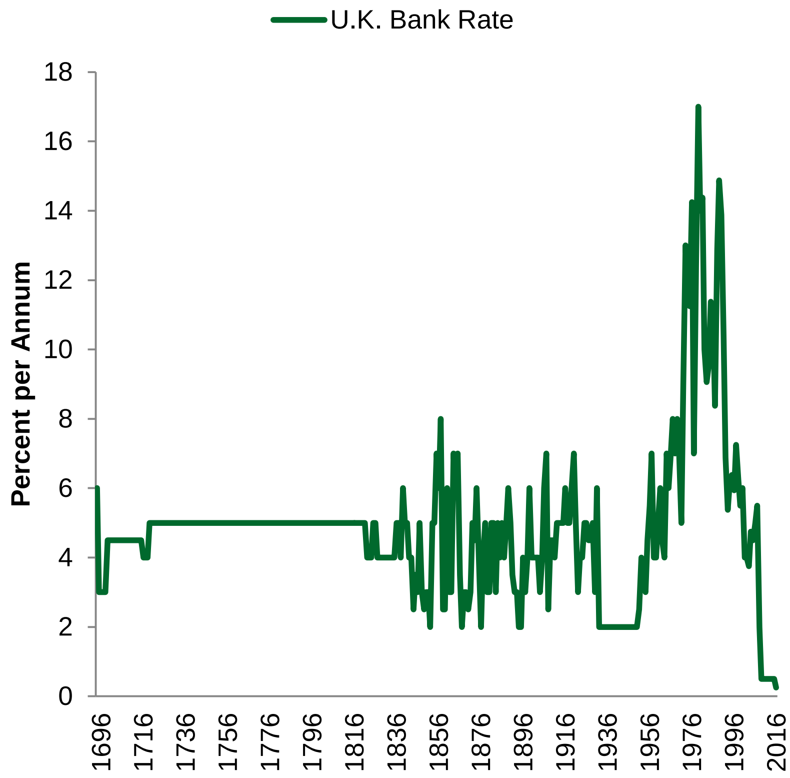
- With regard to the U.K., many observers have been surprised by the resiliency of its economy.
- The chart displays the Citigroup Economic Surprise Index for the U.K.
- Even before the Brexit vote in late June, this statistic was starting to improve. But the magnitude of positive surprises since then has been rather surprising.
- Nevertheless, it is way too soon to sound the all-clear for the U.K. economy.



Source: Citigroup, SEI

# How low can the BOE go?

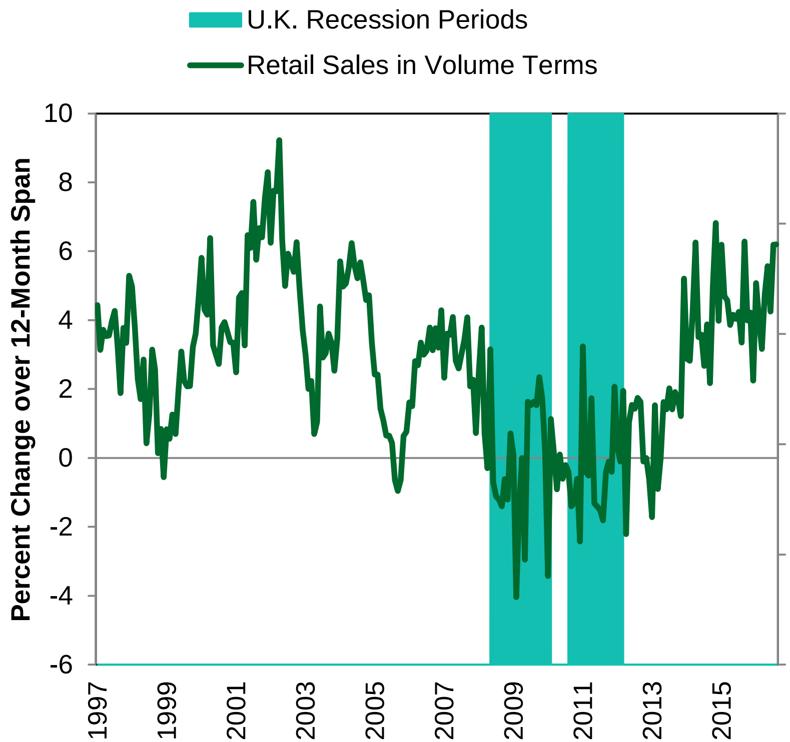
- The Bank of England has preemptively cut its base rate to the lowest level in the long, multi-century history of the central bank.
- It also has restarted its quantitative-easing program and previously successful funding-for-lending scheme.
- On the fiscal policy side, new Chancellor of the Exchequer Philip Hammond jettisoned his predecessor's austerity plans and is expected to introduce a new budget in November (the "Autumn Statement") 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 ease well before the negative effects of Brexit can be felt.




**Source: Bank of England**
*As of 31/08/2016*

# Shopping 'til they drop

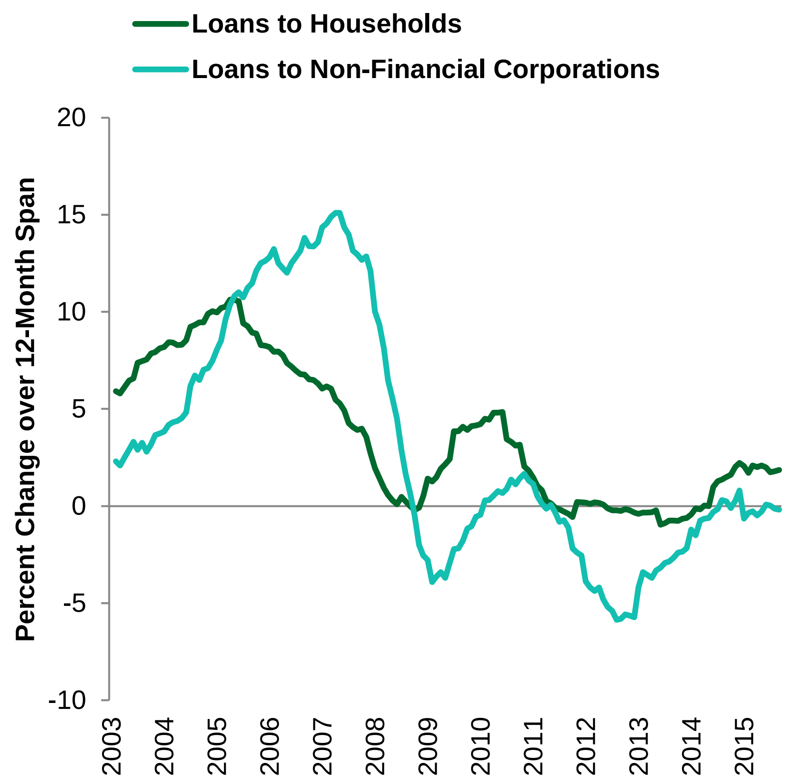
- At this point, the U.K. economy even appears to be growing at a slightly better clip than that of the U.S.
- Although some sentiment indicators dipped in reaction to the shock of the vote to leave the European Union, other data highlight the fact that economic strength is waxing and not waning.
- Retail sales volumes through August have gained a remarkable 6.2% over the past year, just about matching some of its best performances over the past 15 years.




**Source: Economic Cycle Research Institute, U.K. Office of National Statistics, SEI**
*As of 31/08/2016*

# Mario Draghi's proud achievement?

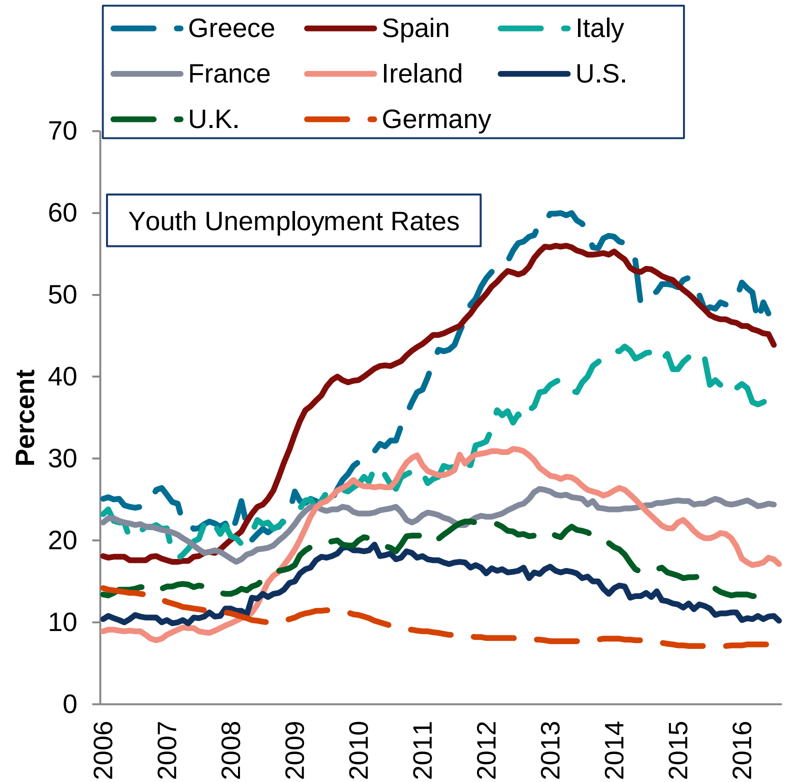
- At his September press conference, European Central Bank President Mario Draghi proclaimed that the central bank's negative-interest-rate and quantitative-easing policies were working just fine.
- As proof, he cited the growth in household and business loans. Count us as skeptics.
- As the chart shows, loans to businesses remain flat as a pancake, consistent with manufacturing output that has also flatlined during this period.
- Loans to consumers have risen, but year-on-year growth has been running at only 2% — less than half the gain registered in both 2010 and 2011.




**Source: European Central Bank, SEI**
*As of 31/08/2016*

# Europe’s lost generation

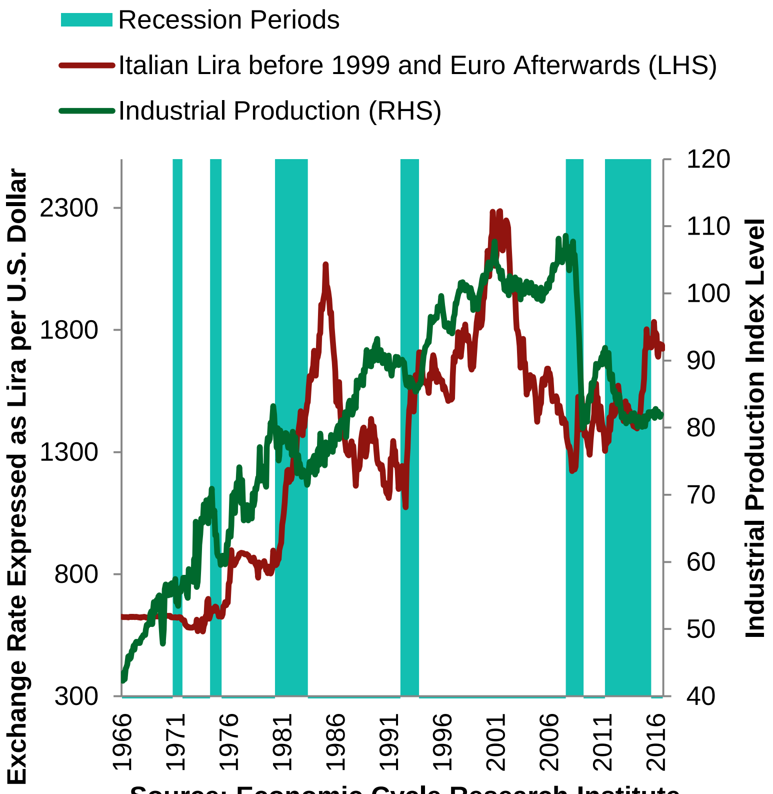
- Although the labour market has certainly improved over the past three years —with the eurozone unemployment rate falling to 10% from 12% — the country-by-country levels remain wildly disparate.
- This is especially so for the youth unemployment rate (which measures unemployment among those less than 25 years of age).
- The chart clearly shows that the periphery countries of Greece, Italy and Spain continue to endure extraordinarily high rates of joblessness among younger people.




Source: Eurostat,
Bureau of Labor Statistics (U.S.), SEI

# Italy and the euro: A difficult marriage

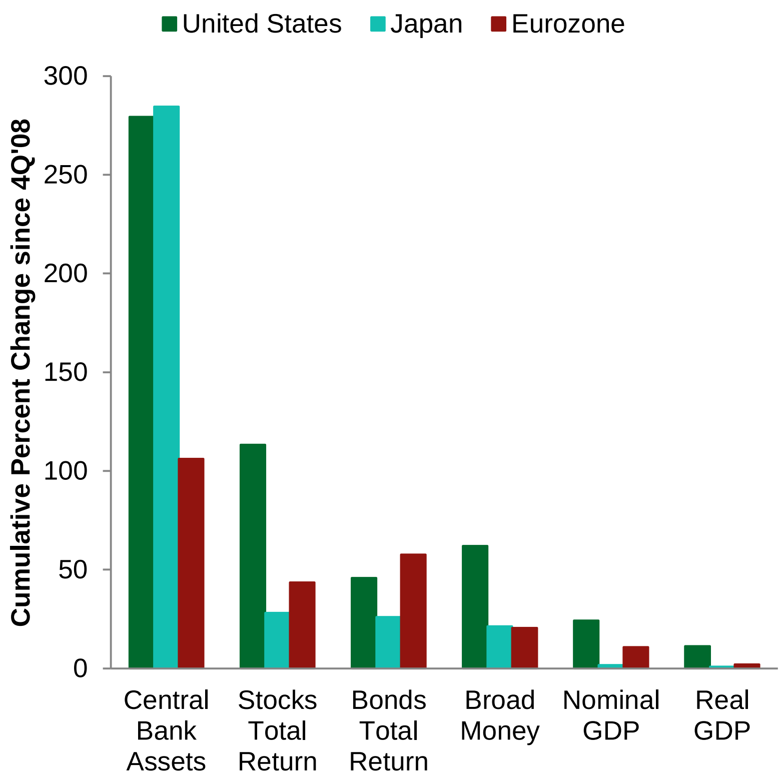
- Prior to 1999 and the creation of the monetary union, the lira was a chronically weak currency. Inflation was a major problem too.
- Periodic currency depreciation, however, was an important release valve for the economy, offsetting the decline in the country's manufacturing competitiveness that would have otherwise occurred as unit labour costs rose.
- Unfortunately for the Italians, entry into the monetary straitjacket of the euro also coincided with China's rise as an export powerhouse.
- We have little doubt that an independent Italian central bank would have weakened the lira considerably during the 2008 financial crisis.




**Source: Economic Cycle Research Institute, FactSet, WM/Reuters, SEI**

# Lots of effort, little result

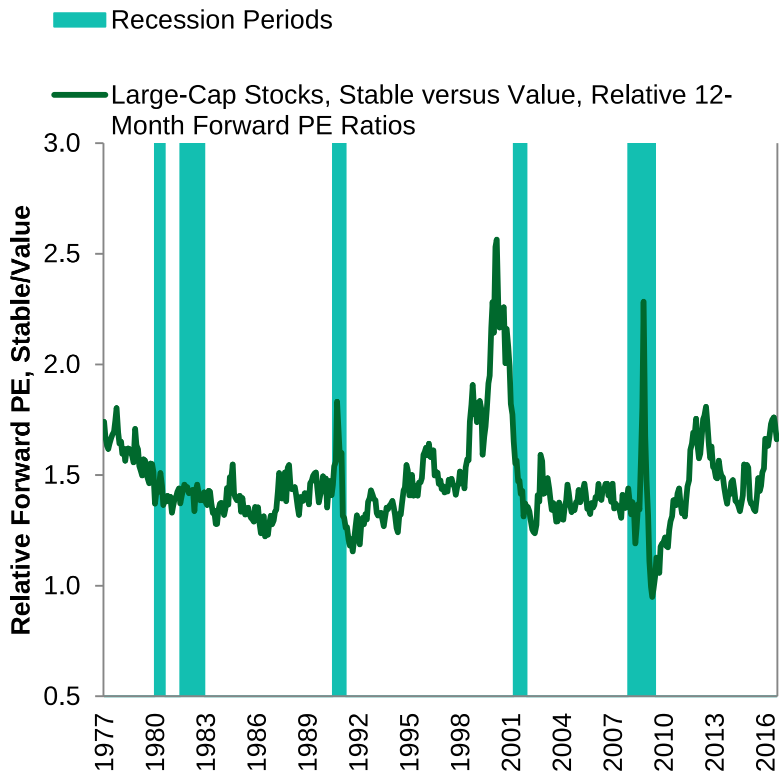
- The chart is a reminder that quantitative easing has not exactly been a stunning success anywhere in the world, especially when it comes to boosting economic growth.
- Since the fourth quarter of 2008, the Bank of Japan and the U.S. Federal Reserve have nearly quadrupled their assets. The European Central Bank has only doubled its assets, underscoring the central bank's late start in this reflation game.
- All this liquidity, though, has done little to boost either nominal or inflation-adjusted gross domestic product.
- It's true that stocks and bonds have responded positively to this monetary manipulation to some degree (more in the U.S., less elsewhere), but asset reflation has not boosted economic growth to acceptable levels or lifted the inflation rate in Japan and Europe toward their target levels.




**Source: FactSet, SEI**
*As of 30/06/2016*

# Stability at a premium in the U.S.

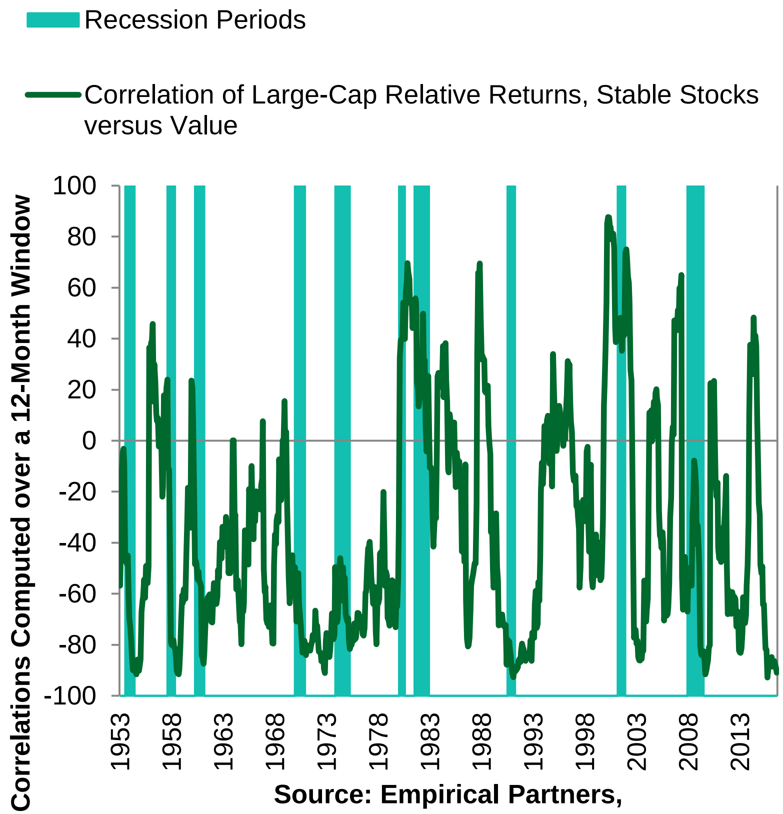
- We have noted that our portfolios have an overwhelming preference for the equity of companies with value characteristics (such as low price-to-earnings and price-to-book ratios), as low-growth, high-yielding sectors (such as utilities) and consistent growers (like consumer staples) are generally expensive and unappealing on a total-return basis.
- Michael Goldstein, founder of Empirical Partners, has done a great deal of work studying this phenomenon.
- His findings show that stable stocks are trading at close to a 70% premium to value stocks, in terms of forward price-to-earnings ratios.




**Source: Empirical Research Partners, Economic Cycle Research Institute, SEI**

# Stability and value, like water and oil

- While stable issues are pricey relative to value stocks, we find the extremely high negative correlation between the two even more remarkable. That correlation is a negative 90%.
- The chart illustrates that this is likely as extreme as it gets.
- Until this negative correlation reverses, investors need to make a choice.
- Either they assume that bond proxies and stability-oriented issues continue to run to the upside despite their high premium to value, or value stocks come back into favour.
- In general, SEI's portfolios favour the reversion trade.




**Source: Empirical Partners, Economic Cycle Research Institute, SEI**
*As of 31/08/2016*

# Important Information

# QIR: Important information

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**CONTINUED OVERLEAF**

# QIR: Important information (continued)

**In addition to the usual risks associated with investing, the following risks may apply:**

- 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.
- 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.
- Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.
- Narrowly focused investments typically exhibit higher volatility.
- Securities focusing on a single country may be subject to higher volatility.
- Investments in smaller companies typically exhibit higher volatility.

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