Quarterly Market Commentary: Equities Jump, Bonds Dump to End 2016

Fourth Quarter 2016

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- There were plenty of headlines during the quarter including U.S. election results, a U.S. Federal Reserve rate hike and an oil production cut led by the Organization of the Petroleum Exporting Countries.
- Fixed-income markets struggled with the notable exception of U.S. high-yield bonds, while equities overall were stronger despite uneven performance across sectors and countries.
- Although equity valuations are elevated in the U.S. versus Europe, Japan and many emerging markets, there is still confidence that earnings will grow robustly on a per-share basis.

Economic Backdrop

The final quarter of 2016 offered several landmark developments: a surprise outcome to a sharp-elbowed U.S. presidential election handed firm control of the federal government to Republicans, bolstering a substantial rally in U.S. stocks and downturn in bond markets; the U.K.'s Brexit timeline and negotiating posture evolved from abstract to relatively firm as a High-Court decision subjected the plan to Parliamentary approval; and the oil-price recovery found solid footing as Organization of the Petroleum Exporting Countries (OPEC) members and non-members agreed to cut production.

Major central banks made headlines, most notably with the U.S. Federal Open Market Committee's rate increase and firmer policy-tightening projections for 2017 as the U.S. dollar continued its run-up. The European Central Bank (ECB) announced an extension of its asset-purchase programme, further loosening its monetary-policy stance; although at a lower level (which could be considered tightening), sending mixed signals. The Bank of England (BOE) announced no changes, and Governor Mark Carney quashed rumours of his resignation (at least until Brexit negotiations conclude in 2019). The Bank of Japan, arguably 2017's most intrepid policy tester, had a quiet quarter as the yen continued to depreciate.

The U.K. unemployment rate dipped to 4.8% in October, markedly lower than the 5.2% rate from a year earlier and the lowest level since September 2005. Consumer prices in the U.K. climbed 0.2% in November, largely due to clothing and footwear price increases. Year-over-year prices received a 0.3% boost, bringing them to 1.2%, the highest level since October 2014. Producer prices were subdued. Aside from petroleum prices, which fell by 1.1%, output prices were muted. Input costs dropped by 1.1% for the month, with their annual rate increasing to 12.9%. Retail sales in the U.K. decelerated in November, rising just 0.2% in the month. Third-quarter economic growth expanded in its final estimate, reaching 0.6% for the period.

Eurozone inflation hit 1.1% in December the highest annual rate in more than three years. The Markit eurozone manufacturing purchasing managers index strengthened to 54.9 in December. The reading, which reached its highest level since April 2011, indicates sharp improvements in output, new orders and employment. Depreciation in the euro improved competitiveness, according to producers. The latest third-quarter gross domestic product (GDP) reading revealed 0.3% growth, in line with prior estimates and equalling second-quarter growth.

U.S. labour-market conditions continued to improve as the unemployment rate decreased by 0.3% to 4.6% in November. Consumer prices rose by 0.2% in November and by 1.7% in the year over year. Energy advanced by 1.2%, led by gasoline, while food prices were flat. Producer prices lifted 0.4% in November despite energy's stumble. Retail sales inched up by just 0.1% in November. Auto sales, which had been a driving force in previous months, had its sharpest decline since March, dropping by 0.5%. However, consumer spending remained strong, with restaurant spending and furnishing/furniture spending both posting impressive gains. November's industrial-production reading was weak, falling 0.4%. Mining gained 1.1% in the month, but could not overcome anemic motor-vehicle production, which slid 2.3%; consumer-goods production and business-equipment production also disappointed. The final release of real GDP revealed the economy grew at a 3.5% annualised rate in the third quarter, stronger than prior estimates and a significant improvement over the second quarter's 1.4% growth.

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Market Impact[1]

Fixed-income markets were largely negative as yields rose (prices and yields move inversely) around the world. Global treasuries and emerging-market debt (in particular local-currency-denominated debt) performed poorly. Given the strength of the U.S. dollar, investments hedged to that currency outperformed, but still generally posted losses. In the U.S., the securitised sectors exhibited moderate declines while corporates and Treasurys suffered more. High yield notably diverged to post gains, most of which came after the OPEC announcement to limit oil production.

Global equity markets, as reflected by the components of the MSCI AC World Index (Net), moved higher during a somewhat uneven fourth quarter. Russia, Greece and Italy all notched double-digit gains. U.S. stocks contributed meaningfully to the gains as the election of Donald Trump brought with it a number of pro-growth campaign promises. Egypt was the worst-performing country by a large margin. A number of other emerging-market countries, including the larger markets of China and South Korea, also fared poorly. Financials were the top-performing sector, followed at a distance by energy and materials. More-defensive sectors generally performed worse; consumer staples, healthcare and utilities all suffered declines.

Index Data (Fourth Quarter 2016)

- The MSCI AC World Index (Net), used to gauge global equity performance, rose by 1.19%.
- The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, declined by 7.07%.
- 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 modestly in the quarter as a whole, moving from 13.29 to 14.04, but spiked to 22.51 on 4 November.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, were volatile, moving from $48.42 a barrel on the last day in September to $53.72 at the end of the year, falling as low as $43.32 on 11 November.
- The U.S. dollar strengthened notably against the world's major currencies, ending December at $1.24 versus sterling, $1.06 against the euro and at 116.6 yen.

SEI's View

Change is coming in many aspects of U.S. policy — economic, social and diplomatic. We expect the new President to drive a great deal of activity in the months ahead that aims to break down disincentives to hiring, bank lending, new-business formation and investment. Investors are betting that the shake-up in Washington will lead to higher growth and profitability — as well as higher inflation. We suspect this reaction is, more or less, the right one. Nonetheless, since there are still more questions than answers regarding the details, investors need to be prepared for a more volatile ride as 2017 unfolds.

So what do we think we know about future U.S. economic policy? Some of it (tax and regulatory reform) should be positive and increases our optimism that economic growth will accelerate. Taxes and regulations top the list of problems facing small businesses — the traditional primary job creators. Interestingly, the quality of labour is quickly becoming a greater concern too, reaching a level not seen in two decades. This is typically a late-cycle phenomenon that occurs as the economy nears full employment.

Some other policy expectations (up-ending trade agreements and confronting China) could be dangerous unless those changes are nuanced and focused, characteristics that have not been in evidence up to this point. The biggest impediment to a favourable U.S. investment environment involves the changing trading relationship between China and the U.S., the two most important economies in the world. The geopolitical dimensions of the relationship cannot be ignored either.

Global bond yields, of course, have soared in the aftermath of Trump's election victory, reflecting a pronounced rise in inflation expectations. Inflation in the U.S. has been percolating beneath the surface for a while, hidden by a combination of dollar strength and energy-price weakness. Surprisingly, commodity prices have been rather resilient since the U.S. elections. We wonder how long this will be the case, if the dollar maintains its upward trajectory as we expect. If the

[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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Federal Open Market Committee forecast assumes that real GDP growth will be constrained as the economy approaches full employment, one can question whether inflation can indeed be contained at or below 2% this year and next.

The winds of political change are blowing through Europe too. Italy's referendum on December 4 already has led to the resignation of Prime Minister Matteo Renzi. Establishment parties are now working to change the rules of the game to make sure Beppe Grillo's Five Star Movement fails to gain the seats necessary to form a government when the next election comes.

General elections will be held in the Netherlands, France and Germany this year. Of these three, we judge the French presidential elections to have the greatest importance for investors. The first round will be held April 23, with the final round scheduled for May 7. It looks likely that voters will select from a final-round match-up between François Fillon, the centre-right Republican candidate, and Marine Le Pen, the leader of the ultra-nationalist National Front. French voters are facing a binary decision: they either take a lurch toward Thatcherite conservatism that promises to undo a portion of the welfare state but has the potential to be very positive for the French economy and financial assets, or they take a gamble on economic nationalism that could lead to the unravelling of the euro-currency framework.

While political considerations remain a source of angst in Europe, economic growth actually has been surprising observers to the upside lately. This improvement simply may reflect some easing of the immediate concerns surrounding Brexit. The U.K. government continues to release various trial balloons ahead of the start of formal negotiations with the European Union (EU). The latest line offered up by the May government seems to be emphasizing a "soft-Brexit" approach that will be less disruptive to trading relations between the U.K. and the EU.

Negotiations don't formally begin until Article 50 is invoked at the end of March, and investor attitudes could again turn cautionary in the months ahead. Besides, the other 27 member countries of the EU may want make an example of the U.K., showing how costly it can be for a country to exit. We expect a tough period of negotiation that could lead to yet another period of investor uncertainty and angst. In the meantime, the better economic numbers offer a welcome respite. This optimism is reinforced by the renewed weakness in the euro against the dollar.

Emerging markets had a seriously negative reaction to the Trump election. Concerns about the new administration's stance on trade and resumption of the dollar's appreciation are the main factors for the setback. If emerging markets are to outperform their developed-market counterparts on a sustained basis, we think the world needs to see a major step-up in economic growth and global trade. Faster growth in the U.S. certainly helps, but the maintenance of open markets and strong trading relationships are crucial too. The aggressive approach toward trade issues likely to be adopted by the Trump administration leaves investors with an uncertain outlook.

Since the election, investors have focused on the positive aspects of President-elect Trump's surprising electoral victory and the end of legislative gridlock. There will be times in the year ahead when the more worrisome and controversial initiatives pushed by the Trump administration will rattle investor confidence. If and when those times come, we would view U.S. equities as attractive. Although equity valuations are elevated in the U.S. versus Europe, Japan and many emerging markets, there is still confidence that earnings will grow robustly on a per-share basis as economic growth, tax reform and a sharp turnaround in energy-sector profitability push year-on-year earnings growth higher.

Glossary of Financial Terms

- High-yield debt: High yield debt is rated below investment grade and is considered to be riskier.
- Securitised debt: Securitised debt consists of a portfolio of assets, such as mortgages or bank loans, which have been grouped together and repackaged as individual securities.

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