Economic Overview
Quarterly Investment Review

Fourth Quarter 2016

SEI New ways. New answers.®

Point of View

Economic Outlook

The Outlook: A Year of Big Changes Ahead

The good news

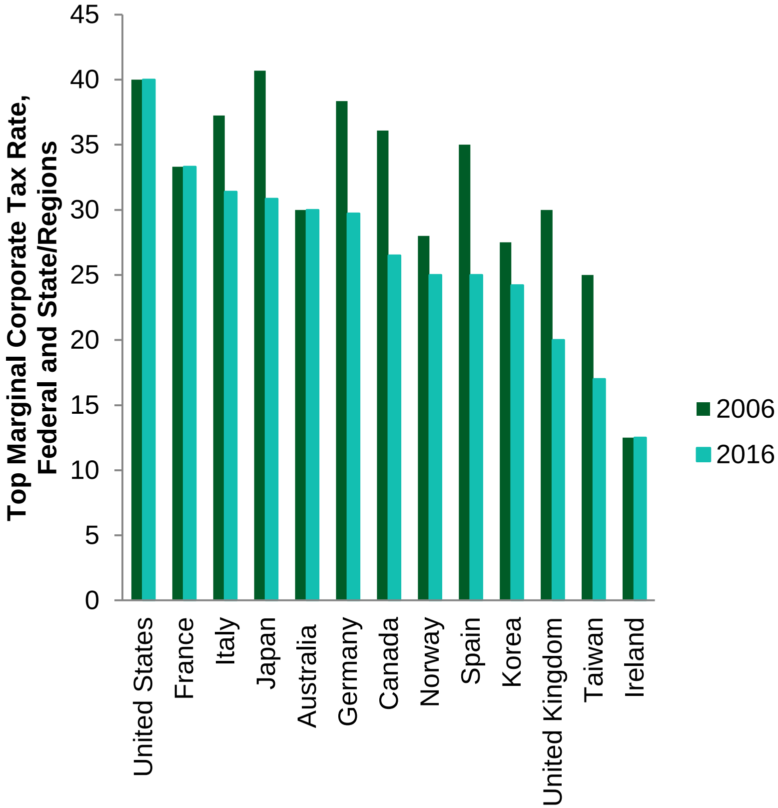
- The election of Donald Trump, the maintenance of Republican majorities in the House and Senate, and overwhelming Republican representation at the state level pave the way for dramatic changes in U.S. economic, diplomatic and social policies.
- Tax reform, both corporate and individual, is high on the U.S. agenda. We expect a boost to after-tax earnings, cash flow and incomes. Major regulatory reform also will likely proceed, with the aim of reducing the cost of doing business and increasing incentives to hire.
- European economic activity has improved in recent months despite the potentially disruptive impact of Brexit and rising political uncertainty.
- Our equity funds generally remain positioned to benefit from better economic growth, with overweight exposures to banks, energy and materials. Fixed-income managers are focusing on credit and curve-flattener strategies. Currencies are being actively managed, with a long U.S. dollar position as a common theme.

The bad news

- The Trump Administration's shift to a more combative stance on trade, especially regarding China, could rattle investor confidence.
- Fiscal stimulus at a time when the U.S. unemployment rate is already well below 5% could lead to a faster-than-expected acceleration in inflation and force the Fed to tighten policy more aggressively.
- Populist politics will continue to be a concern in Europe. Elections in France this spring could prove pivotal for European markets and the euro.
- The economic disruption posed by Brexit should come into better focus in 2017 as negotiations begin in earnest.
- Emerging equity markets have endured a sharp correction in the aftermath of the U.S. elections. An aggressive U.S. stance on trade and continued dollar strength leave emerging market investors with an uncertain macro outlook.

Deep in the heart of taxes

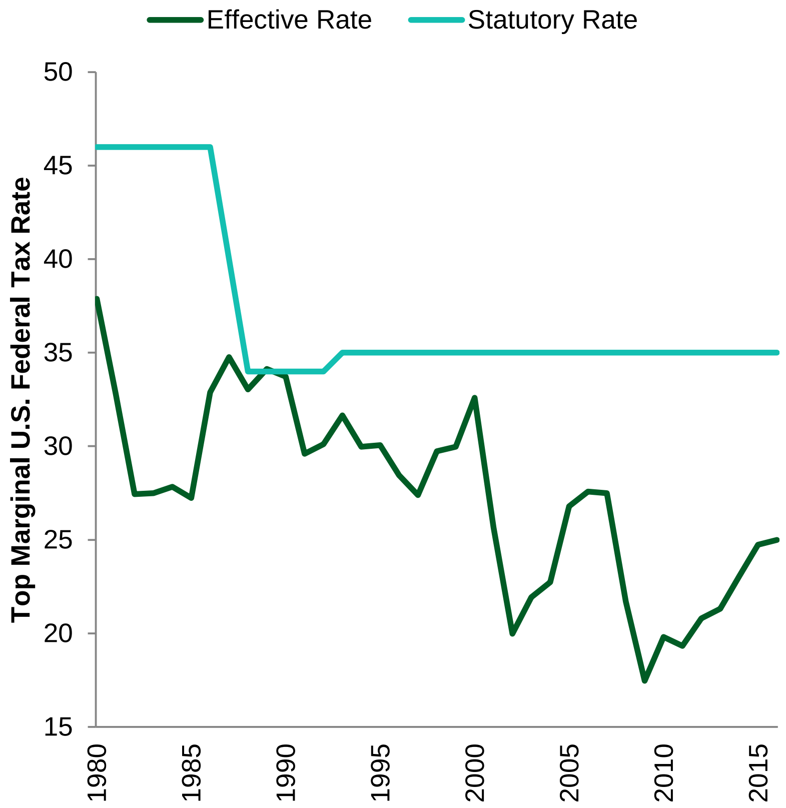
- U.S. corporate marginal tax rates are set to decline.
- The incoming Trump administration has suggested a 15% top statutory rate versus the current 35%.
- That would take the U.S. from the highest statutory rate among developed countries to almost the lowest.
- As the chart illustrates, the representative top marginal tax rate on U.S. businesses (federal plus an average estimate for state/local tax regimes) hasn't changed over the past 10 years.
- Most countries, by contrast, have lowered their top corporate tax rate in an effort to stimulate economic growth.



Source: KPMG, SEI

It will be hard to close this gap

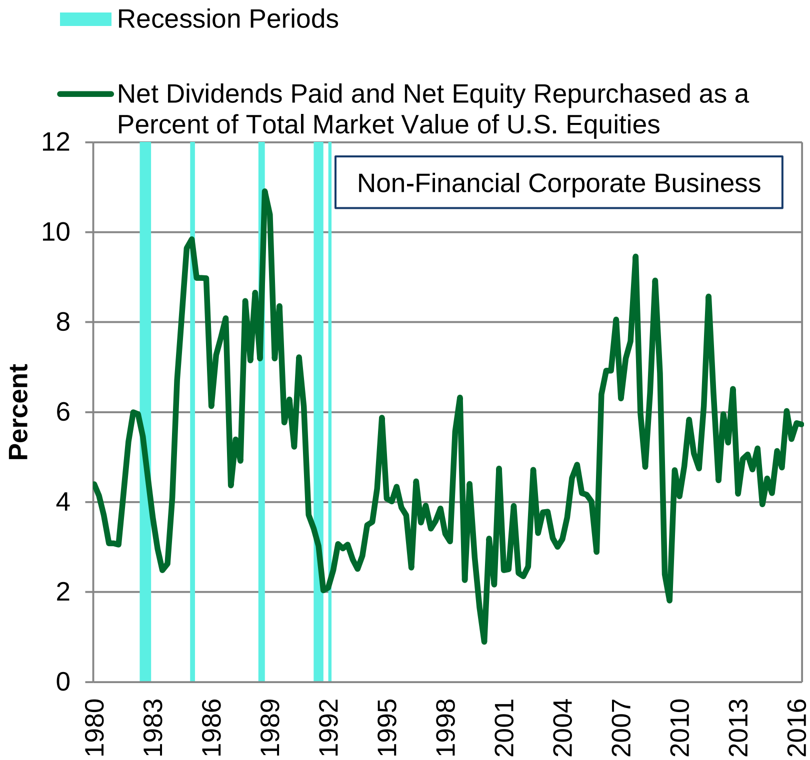
- The chart highlights the yawning differential between the U.S. federal statutory tax rate (reflecting the tax rate set by law) and the effective rate (which reflects what corporations actually pay).
- Currently, corporations pay an effective tax rate of about 25%; domestically oriented, service-producing companies pay close to the top rate of 35%.
- A 15% rate may be hard to achieve given corporate-tax lobbyists' power to maintain beneficial tax loopholes for their clients.
- Still, a tax cut to 20% and reforming the tax code to tax earnings on a territorial basis instead of globally (as is done in other countries) would be a marked improvement over the current corporate-tax regime.



Source: Oxford Economics, Tax Policy Center, SEI

Sending cash back to shareholders

- The chart examines the Federal Reserve's (Fed) Flow of Funds data as it pertains to the cash flows of non-financial U.S. corporations.
- To gain an even better appreciation of the overall impact of repatriation, we look at the sum of (1) net dividends paid to investors and (2) the net equity repurchased by non-financial corporations as a percentage of the total market value of U.S. equities (the higher the ratio, the greater the amount of money flowing to investors for each dollar of stock-market value).
- As of the third quarter, this ratio amounted to 5.7%, slightly above the 5% average for the past 30 years.

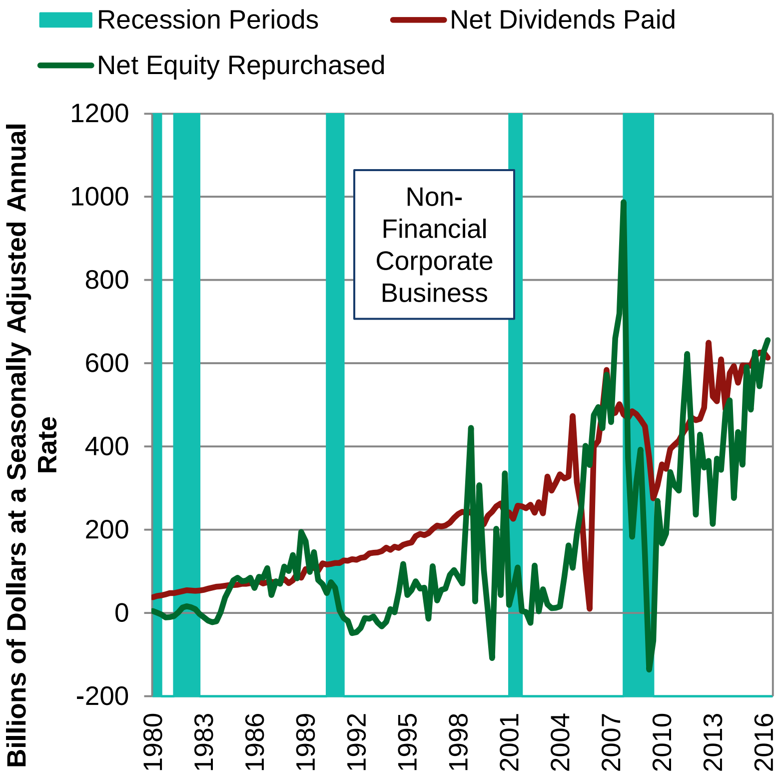


Source: Economic Cycle Research Institute, Federal Reserve Board, SEI

Data as at 31/3/2016

U.S. stock buybacks are popular

- Between 1983 and 1984, the sum of net dividends paid and net equity repurchased by non-financial corporations as a percent of the total market value of equities rose rapidly as stock buybacks became an important use of corporate cash.
- A second burst of stock buybacks occurred at the start of the 1998-1999 technology bubble.
- During the 2004-2006 repatriation tax holiday, stock repurchases took off in an unprecedented fashion.
- The 2007-2009 global financial crisis, by contrast, witnessed a precipitous slide in both dividends and stock buybacks to 2004 levels.
- Today, we see little evidence that stock buybacks or dividend payments are going out of style; although limits on interest deductions may change that calculus for some companies.

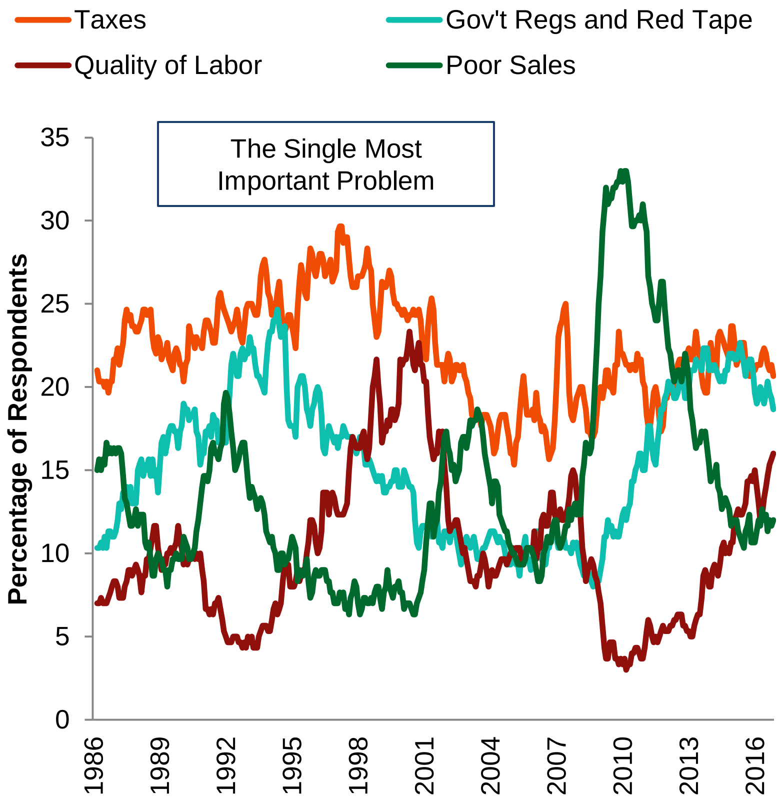


Source: Economic Cycle Research Institute, Federal Reserve Board, SEI

Data as at 31/3/2016

The biggest problems for the smallest businesses in the U.S.

- In addition to tax reform, deregulation will be given a high priority.
- Healthcare, energy and banking appear to be the main focus of early Trump-administration efforts. President-elect Trump's cabinet picks clearly indicate that the administration intends to undo much of the Obama legacy.
- The over-arching goals in these root-and-branch deregulation efforts will be to reduce the cost of doing business and encourage more hiring, especially among small businesses that traditionally have been the primary job creators.
- The chart illustrates the current small-business pressure points, as surveyed by the National Federation of Independent Business.



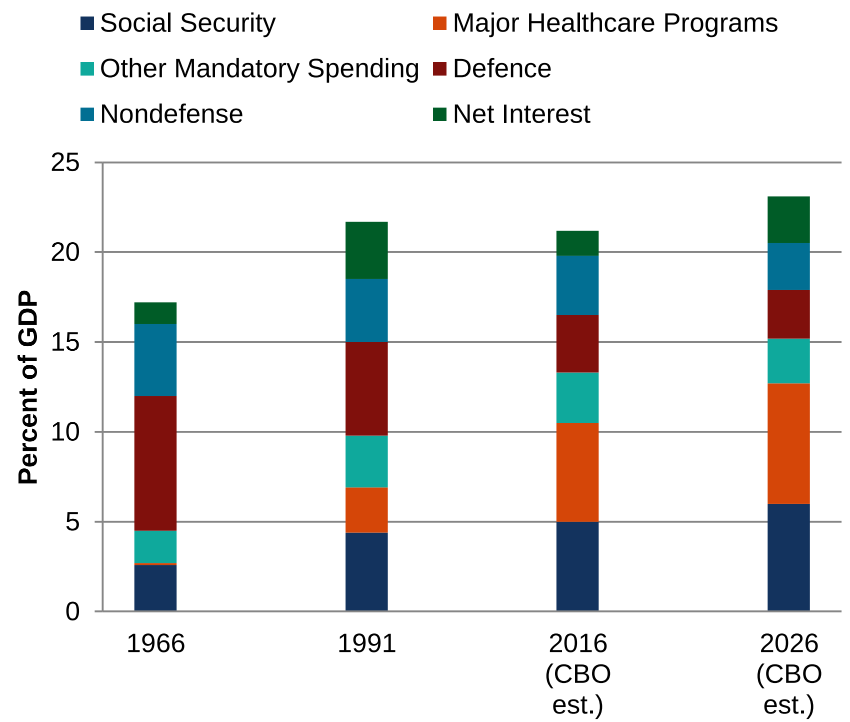
Source: National Federation of Independent Business, SEI

Data through 30/11/2016

Mandatory reading

- We think that over the next two or three years, the U.S. federal budget deficit could expand by more than 2% to 2.5% of gross domestic product (GDP) on a cyclically adjusted basis as a result of tax cuts and additional spending.
- Legislators will be hoping that deregulation and the lifting of various cost burdens will spark a pick-up in economic growth and tax revenues that mitigate the pressure on the government's finances.
- Longer-term, demographic pressures on mandatory spending will be the primary budgetary challenge — as it has been for several decades.
- The chart shows how spending on Social Security, healthcare programs (such as Medicare and Medicaid) and other mandatory income-support programs have progressed inexorably higher.

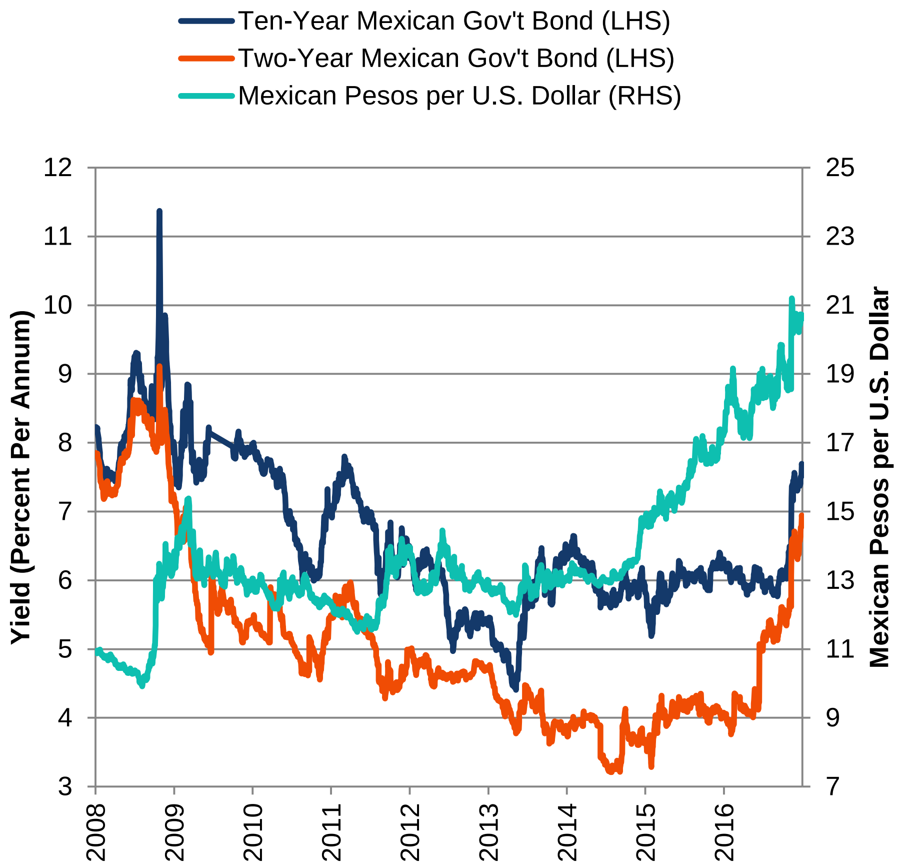
Federal Government Outlays as a Percent of U.S. GDP



Source: Congressional Budget Office, SEI

¿Toro Muerto?

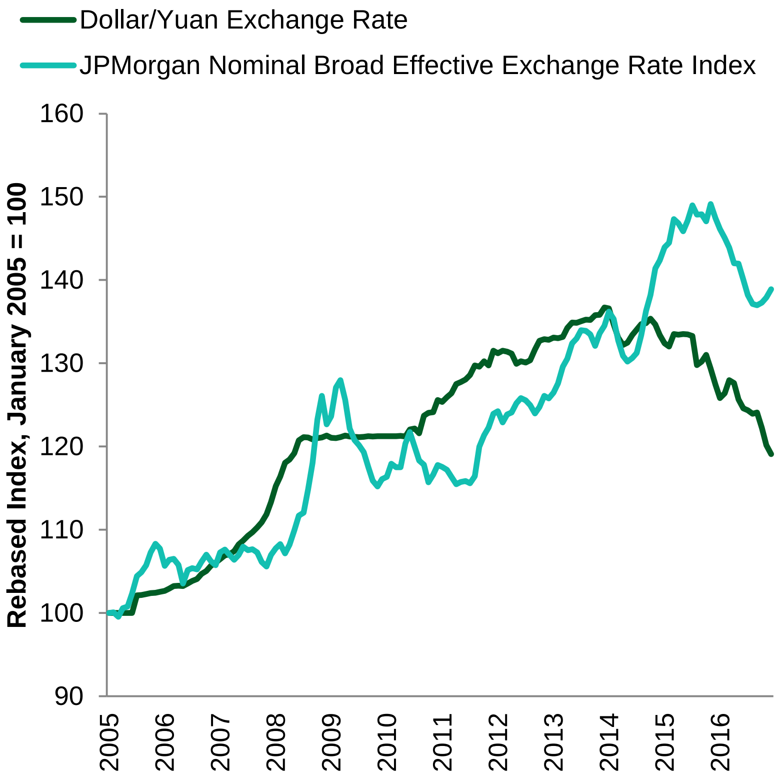
- If President-elect Trump jettisons NAFTA, the disruption to trade will be extensive — running counter to the new administration's pledge to bring back manufacturing jobs to the country.
- We suspect, however, that the agreement simply will be reviewed and modestly adjusted. The Mexican government is already on record saying that it is in favour of "modernizing" NAFTA.
- In any event, investors have reacted sharply to Mr. Trump's fiery rhetoric.
- The Mexican peso has weakened considerably over the past two years, partially on concerns about Mr. Trump's intentions on trade and immigration.



Source: JPMorgan Chase, WM/Reuters, FactSet, SEI

Yuan a piece of me?

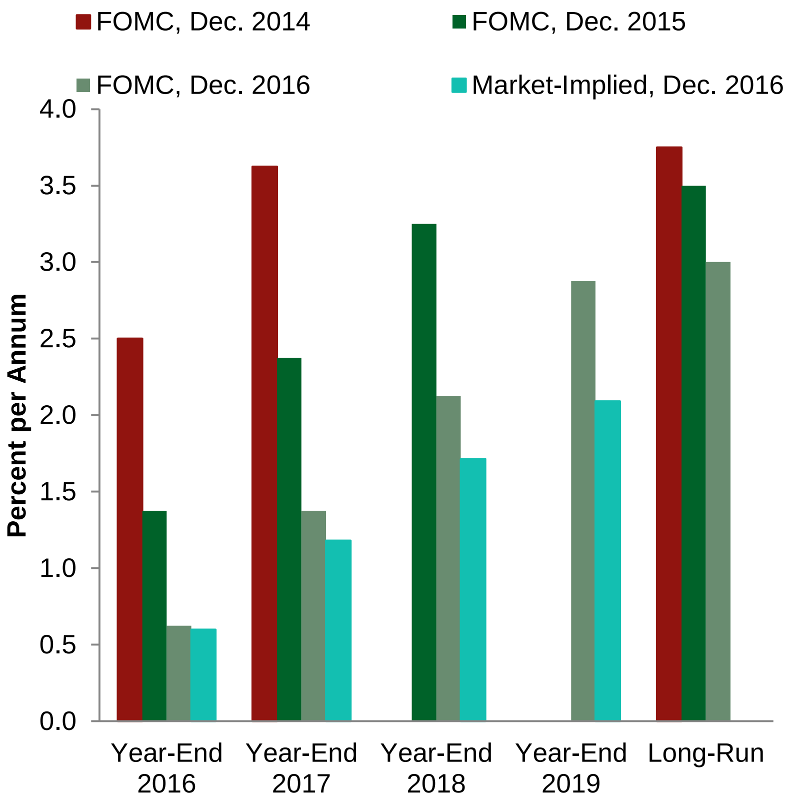
- There is no certainty when it comes to the tactics President-elect Trump will employ to attain a “better deal” on trade.
- That noted, the odds of a confrontation with China seem uncomfortably high to us.
- The accelerating decline in China’s currency against the dollar to its lowest level in more than eight years will not help matters.
- Nor will the incoming Trump administration’s cavalier willingness to shake up political protocol by treating (or is it tweeting?) Taiwan as an independent, sovereign nation.
- Diplomatic relations often depend upon a willingness to turn a blind eye to the facts on the ground. Thus far, President-elect Trump has not shown much in the way of diplomatic nuance.



Source: JPMorgan Chase, WM/Reuters, FactSet, SEI

They will be right some day

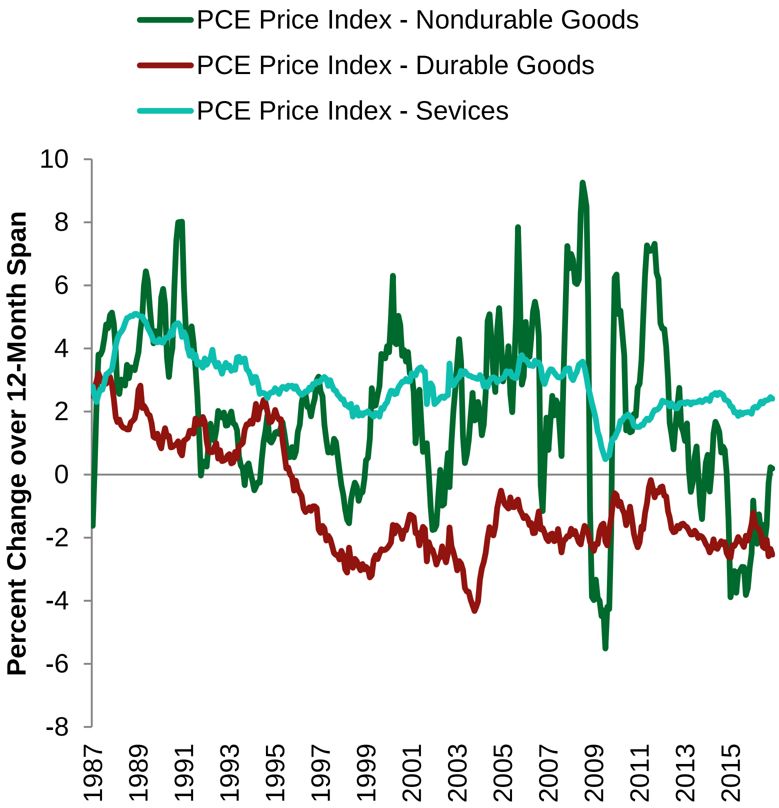
- The Federal Open Market Committee (FOMC) increased its number of projected rate hikes for 2017 from two to three.
- The median FOMC forecast of the funds rate by the end of 2017 is now 1.4%.
- This action should be kept in perspective. As the chart illustrates, the Fed governors and regional presidents have been woefully poor prognosticators of their own future actions.
- A year ago, FOMC members thought they would raise the funds rate to 1.4% by the end of 2016, and to 2.4% by the end of 2017.
- Two years ago, the comparable respective median forecasts for 2016 and 2017 were 2.5% and 3.6%.



Source: Federal Reserve Board, FactSet, SEI

Inflation in services, deflation in goods

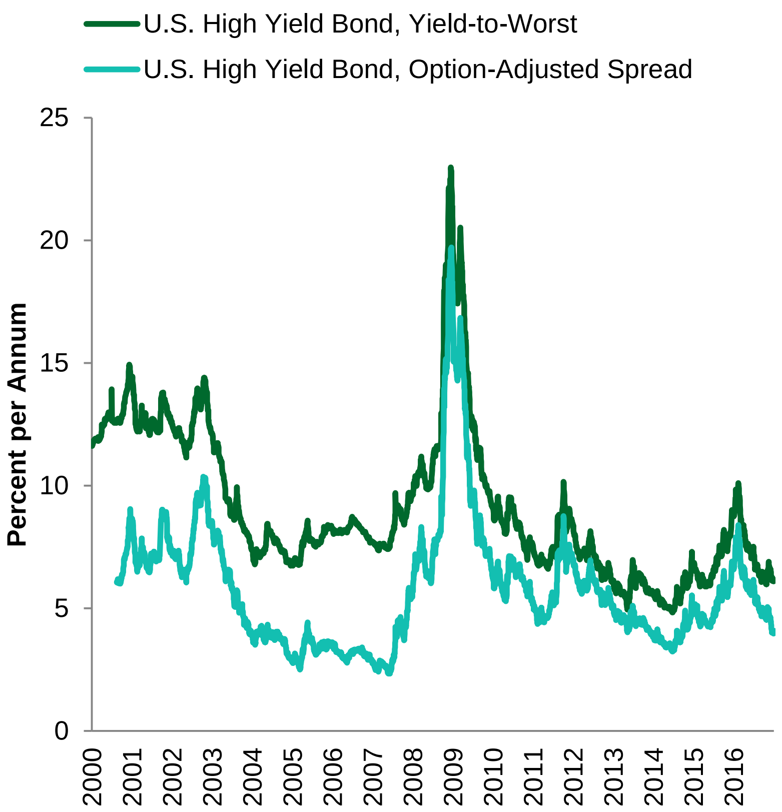
- Using the Fed's preferred inflation yardstick — the personal consumption expenditures price index (PCE Price Index) — inflation in services has accelerated in recent months.
- Deflation remains a feature of goods prices, however, especially for durable items. The dollar's strength is an important factor in pressuring durable-goods prices lower, and the greenback's recent strength suggests this will continue.
- Innovation that lowers the price of computing power over time is another long-lived factor. Lowering costs through outsourcing to developing countries is a third and perhaps most critical factor in the view of the new administration.
- President-elect Trump would likely point at the chart and blame NAFTA because the deflation trend began to take hold in 1995, the year NAFTA took effect.



Source: U.S. Bureau of Economic Analysis, SEI

Sending out an OAS*

- In the high-yield market, option-adjusted spreads versus Treasurys have tightened to their narrowest levels since 2014 on the same economic optimism that has propelled equity prices.
- The jump in energy prices has also relieved pressure on highly indebted oil and gas producers.
- The overall default rate within the U.S. high-yield universe in November 2016 was 5.57%, above the long-term average of 4.5% since 1980.
- The high-yield market appears priced for a default rate closer to 4% by this time next year**.**

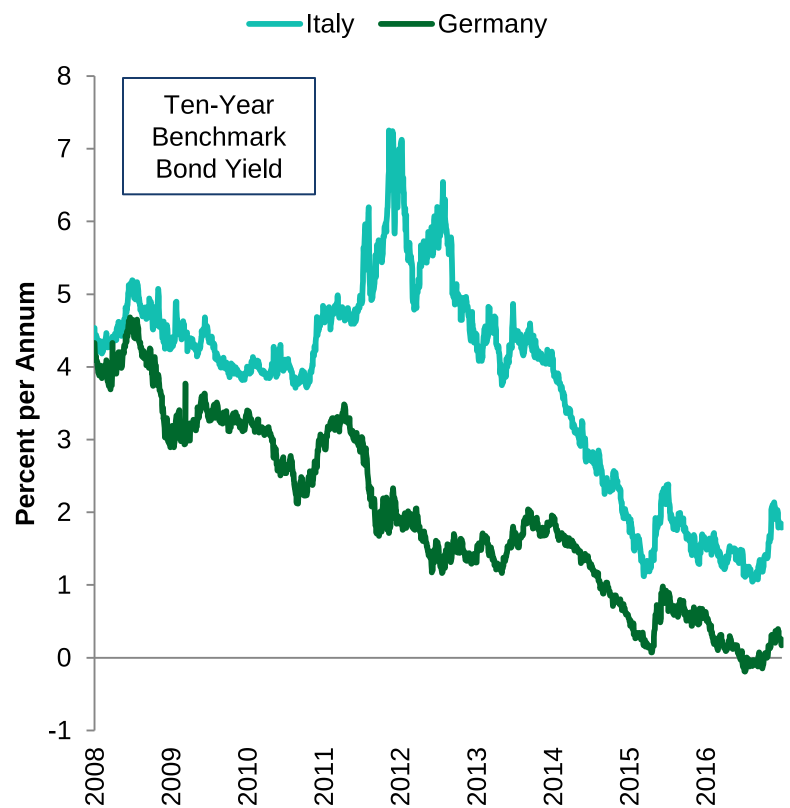


Source: Bloomberg Barclays, SEI

* Option-adjusted spreads estimate the difference in yield between a security or collection of securities and comparable Treasurys after removing the effects of any special features, such as provisions that allow an issuer to call a security before maturity.

The rise and fall of the roamin' Italian bond yield

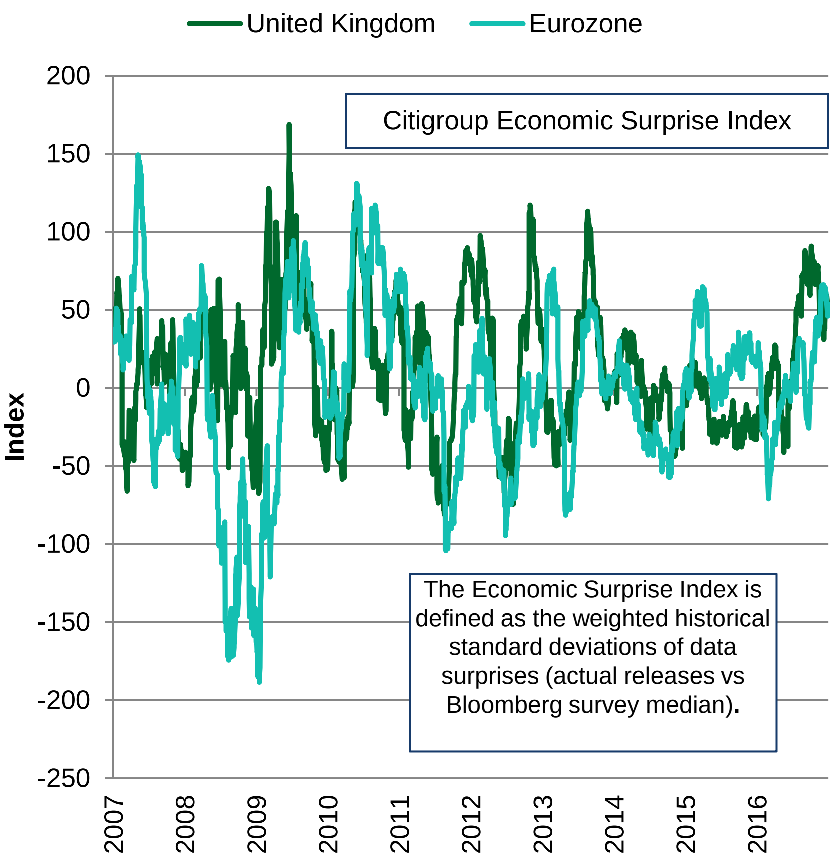
- Yields on Italian 10-year bonds have eased since the referendum, but remain near levels last seen during the Greek debt crisis of 2015.
- Still, at less than 2%, yields on the country's 10-year government bonds do not seem to be pricing in much risk.



Source: Tullett Prebon Information, SEI

Pleasant surprises (for now)

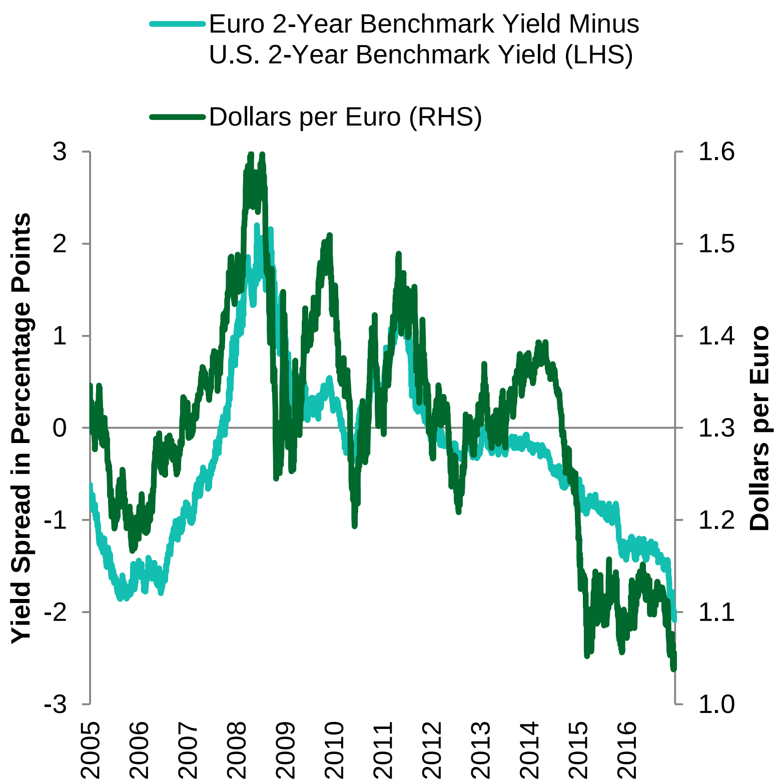
- While political considerations remain a source of angst in Europe, economic growth actually has surprised observers to the upside lately. Citigroup's Economic Surprise Index (which measures the extent of surprise caused by data releases, based on the reaction of the currency market) has improved sharply in recent months.
- Both the eurozone and the U.K. have come out with some upbeat numbers compared to expectations since September and July, respectively.



Source: Citigroup, SEI

As spreads widen, the euro gets squeezed

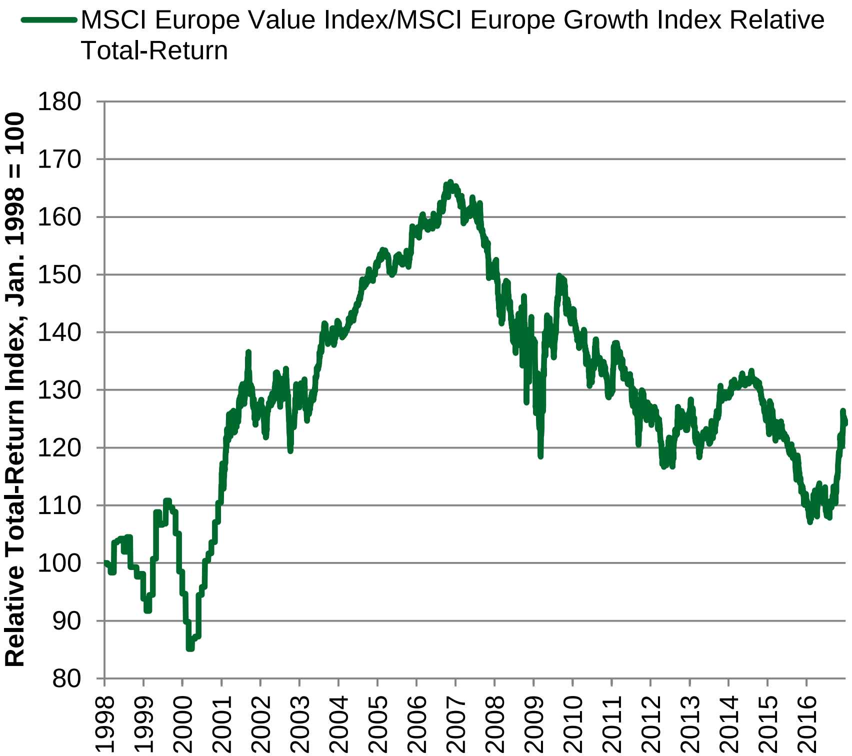
- The European Central Bank's decision to extend asset purchases through the end of 2017 (albeit at a somewhat reduced pace) emphasizes the divergent paths of monetary policy in Europe versus the U.S.
- Interest-rate differentials have widened meaningfully between U.S. Treasury and eurozone (German) benchmark two-year notes.
- That spread recently exceeded two percentage points.
- This should keep the pressure on the euro in the months ahead, since capital flows where it is expected to be treated best.



Source: Tullet/Prebon Information, WM/Reuters, FactSet, SEI

Value makes a run, but still lags growth

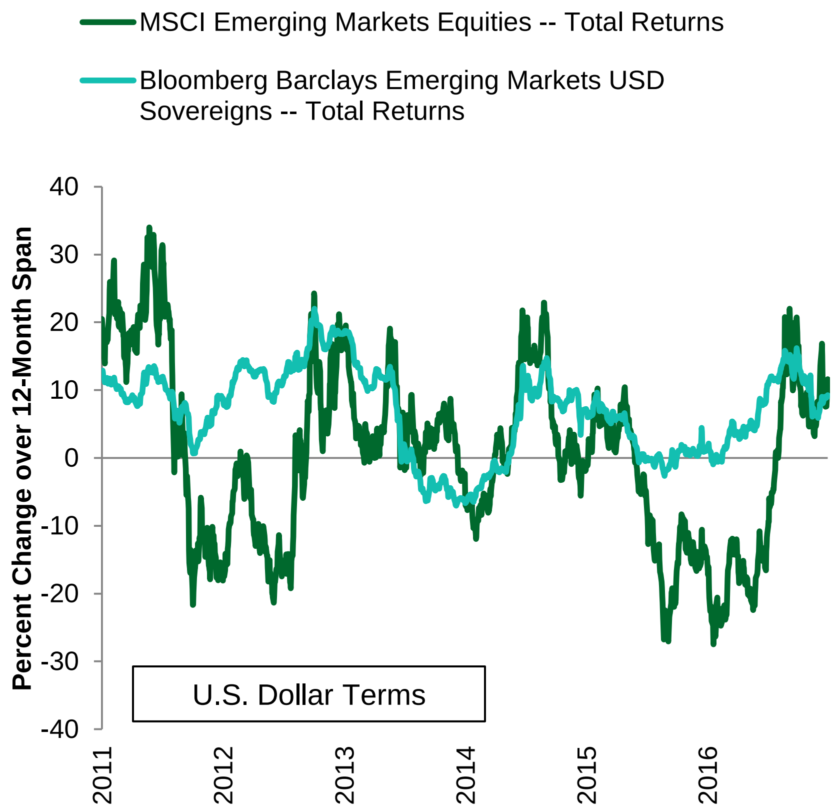
- Our European-equity funds, like our U.S. funds, emphasize value and have a pro-cyclical stance.
- They see more potential upside, since value investing in Europe has been out of favour for a long time.
- Even after the exceptional rise in value versus growth since the summer, the MSCI Europe Value/Growth relative-strength line shown on the chart is still well below where it was 10 years ago.
- Although the sub-advisers overseeing our portfolios are primarily bottom-up stock pickers, they are aware that the twists and turns of the Brexit saga can cause future volatility and create opportunities.



Source: MSCI, SEI

Emerging markets re-emerged in 2016

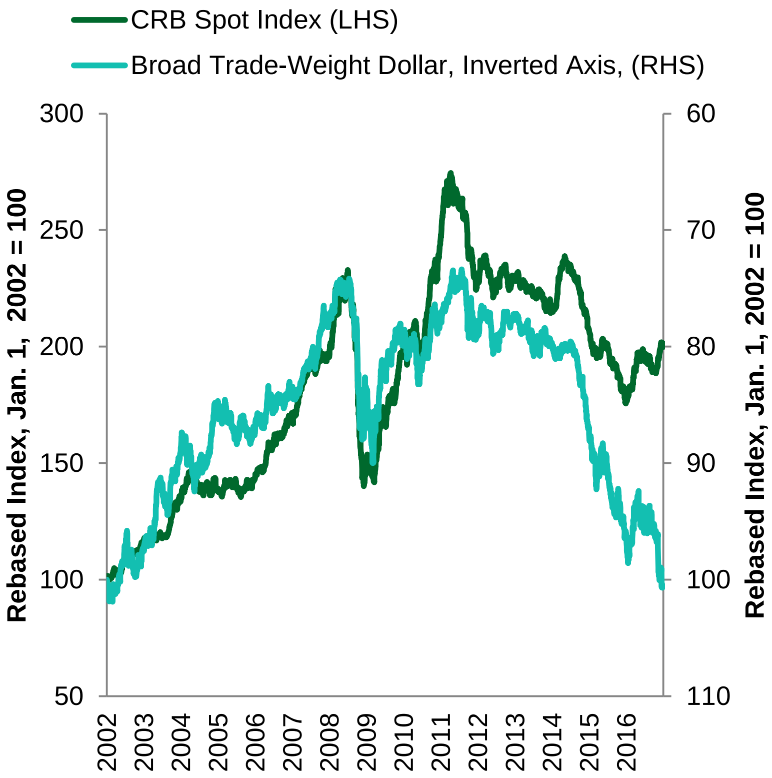
- Emerging markets had a seriously negative reaction to the Trump election.
- Despite the decline, equity and fixed-income emerging market asset classes both recorded respective gains of 11.67% and 9.2% in U.S. dollar-terms for 2016; although year-over-year increases reached 16% for bonds and over 20% for stocks as recently as September.
- Concerns about the new U.S. administration's stance on trade and resumption of the dollar's appreciation are the main factors for the setback.



Source: Bloomberg Barclays, MSCI, SEI

Commodity prices climb in defiance of the dollar

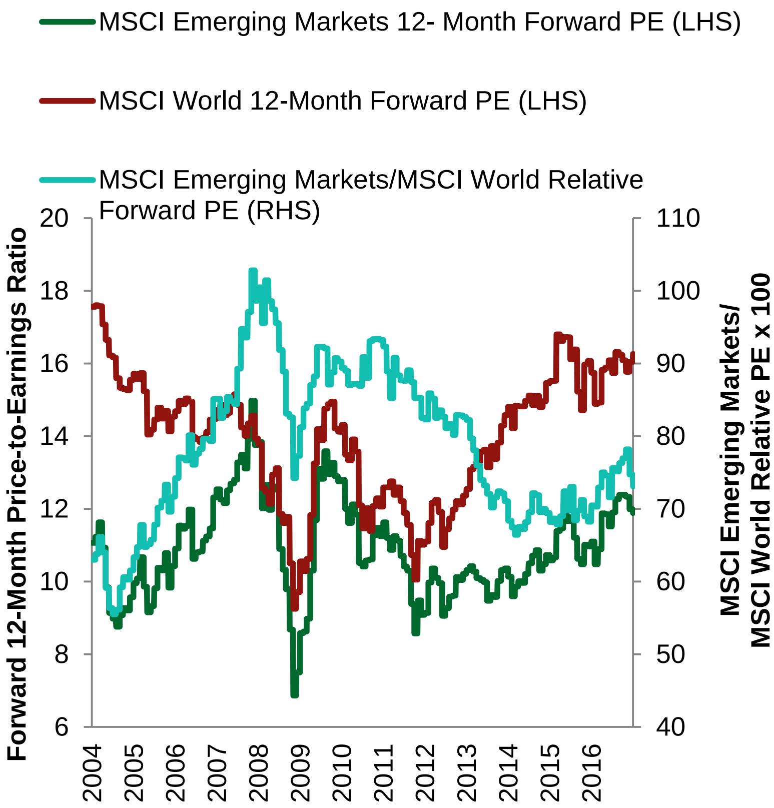
- The chart compares the Commodity Research Bureau's spot index (a measure that excludes the energy complex) against the broad trade-weighted value of the dollar.
- The axis for the trade-weighted dollar is inverted to highlight the strong (negative) correlation between the two series over the past decade or more.
- When the dollar appreciates, commodity prices weaken; when the dollar goes down, commodity prices tend to go up.
- Since the election, however, spot prices have increased even though the dollar has surged.



Source: Commodity Research Bureau, Federal Reserve, SEI

Emerging markets looking forward to better times

- The rise in commodity prices has boosted the earnings of companies that make up the MSCI Emerging Markets Index in dollar terms; the gains nevertheless have been rather disappointing compared to the historical relationship.
- The chart shows that forward price/earnings ratios for the MSCI Emerging Markets Index have risen significantly over the past two years.
- At 12 times the forecasted earnings for the next 12 months, emerging-market forward price/earnings ratios have recovered to their highest levels since 2010.
- While developed-market multiples, as measured by the MSCI World Index, still remain substantially higher at about 16 times, the relative price/earnings ratio premium enjoyed by developed countries has narrowed.



Source: FactSet, MSCI, SEI

Important Information

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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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