Markets Adjust to Political Climate Change

Monthly Market Commentary

January 2017

SEI New ways. New answers.®

- A transition of power descended on the U.S., followed by a persistent stream of executive orders from President Trump — some more contentious than others — and several controversial exchanges with trading partners and allies.
- Global equity markets performed exceptionally well, particularly in South America and the Pacific. Global fixed-income markets also had a good month, led by emerging-market and high-yield bonds (two higher-risk market segments).
- Equity valuations were elevated in the U.S. versus other locales, but we suspect a combination of economic growth, tax reform and a sharp turnaround in energy-sector profitability will push year-over-year earnings growth higher.

Economic Backdrop

The New Year began with realignment in the U.S.: Republicans consolidated their election wins, led by a feverish pace of presidential proclamations from a freshly inaugurated President Donald J. Trump — who became the immediate subject of protests around the world. Cabinet appointees hung at various stages along the path to Senate confirmation as some Democrats asserted their limited powers to highlight the conflicts presented by some candidates. British Prime Minister Theresa May was the first foreign leader to pay a visit to the new administration; upon her return to the U.K., she rebuked the president's executive order to temporarily ban travellers from select Muslim-majority countries from entering the U.S.

A rift widened among key trading partners, as Mexican President Peña Nieto cancelled a visit to the White House in protest of Trump's insistence on a Mexico-funded border wall. The Trump administration also suggested that Germany, China and Japan have actively devalued their currencies to boost economic competitiveness. Central banks either made no monetary policy announcements in January (U.S. Federal Reserve, Bank of England) or kept policy intact (European Central Bank, Bank of Japan).

The U.K. consumer has settled down, with retailers reporting lower sales volumes in January compared to the same period a year earlier after a 1.9% monthly drop in retail sales during December. On the industrial side, manufacturers reported promising conditions in January, depicting export strength, high output and a bright outlook. A sizeable jump in consumer prices during December pushed year-over-year inflation to its highest level since mid-2014 (when global energy prices began to decline). Producer prices were mixed, with input costs expanding somewhat rapidly while conditions were considerably more restrained on the output side. The labour market continued to firm, as claimant-count joblessness fell in December and average year-over-year earnings growth increased during the September-to-November period. Overall economic growth continued apace for the fourth quarter (at 0.6%) and the year over year (at 2.2%).

Eurozone manufacturing grew in January at the fastest rate in more than five years, while services activity also gained traction. Economic sentiment continued to improve; the industrial outlook was especially solid, while consumer confidence also expanded. Inflation was reinvigorated, with back-to-back year-over-year consumer price growth for December and January on the strength of energy, food, alcohol and tobacco costs; the latest reading was the highest since 2013. Unemployment continued to trend lower, hitting a seven-year low of 9.6% in December. Loan demand increased during the fourth quarter at the enterprise, house-purchase and consumer-credit levels; banks were generally accommodating, with modest tightening of credit standards in enterprise and house purchases and looser standards in consumer credit. Gross domestic product (GDP) grew by 0.5% during the fourth quarter — the fastest pace in seven quarters — and 1.8% for the 12-month period ending December.

The U.S. labour market continued to tighten in January, with the highest non-farm payrolls growth since September and jobless claims reaching the one-hundredth consecutive week of coming in below 300,000 after hitting its lowest level since 1973. Manufacturing growth also accelerated, with various measures across several different surveys indicating the most convincing expansion since late 2014. Personal income rose 0.3% in December, while consumer spending moved 0.5% higher and core personal consumption expenditures inflation (the U.S. Federal Reserve's preferred measure) held firm at 1.7%. Fourth-quarter gross domestic product grew by an annualised 1.9%, led by residential and business investment. Personal expenditures also contributed, but by less than in previous quarters, and net exports detracted.

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Market Impact[1]

Global fixed-income markets started 2017 with a boost, as reflected by the Bloomberg Barclays Global Aggregate Index. Higher-risk market segments fared best in January, led at a distance by local-currency-denominated emerging-market bonds. Foreign-currency-denominated (external) emerging-market debt, U.S. high-yield bonds and global sovereign securities also performed well. Global non-government debt and U.S. Treasury inflation-protected securities (TIPS) had a good month, as did U.S. investment-grade corporate fixed income, Treasurys and asset-backed securities. U.S. mortgage-backed securities were slightly negative.

Global equity markets jumped in January, as reflected by the MSCI AC World Index (Net), particularly in South America and the Pacific. Brazil was the top-performing country, trailed closely by Poland. Peru, New Zealand and Singapore also had steep gains. Greece had the most significant losses, followed by considerably smaller declines in Italy, Egypt and Finland. Portugal and Russia were the only other negative-performing countries. In global sector terms, materials trounced the market and information technology also performed considerably well. Energy delivered the only decline, while defensive sectors (consumer staples, telecommunications and utilities) had the most modest gains.

Index Data (January 2017)

- The MSCI AC World Index (Net), used to gauge global equity performance, advanced by 2.73%.
- The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, increased by 1.13%.
- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index also known as the “fear index”, decreased in the month from 14.04 to 11.99.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, fell from $53.72 a barrel at the end of December to $52.81 on the last day in January.
- The U.S. dollar weakened against the world’s major currencies, ending January at $1.26 versus sterling, $1.08 against the euro and at 112.6 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 remain more questions than answers regarding the details of this activity, investors need to be prepared for heightened volatility 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, which increases our optimism that economic growth will accelerate. Taxes and regulations generally top the list of problems facing small businesses, the traditional primary job creators. Interestingly, the quality of labour is quickly becoming a greater concern for business as well, reaching a level not seen in two decades — a typical late-cycle phenomenon that occurs as the economy nears full employment.

Other policy expectations could be dangerous (up-ending trade agreements and confronting China) unless executed with nuance and focus, characteristics not yet demonstrated. 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 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 U.S. dollar strength and energy-price weakness. Surprisingly, commodity prices have been resilient since the U.S. elections. We wonder how long this will be the case, if the U.S. dollar maintains its upward trajectory as we expect. If the Federal

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[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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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 also blowing through Europe. Italy's referendum on 4 December 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 23 April, with the final round scheduled for 7 May.

While political considerations remain a source of angst in Europe, economic growth actually has been surprising observers to the upside lately. This simply may reflect some easing of immediate concerns surrounding Brexit. The U.K. government continues to release various trial balloons ahead of formal negotiations with the European Union (EU).

Investor attitudes could again turn cautionary in the months ahead of negotiations, which formally begin after Article 50 is invoked at the end of March. 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, improving economic numbers offer a welcome respite. This optimism is reinforced by the renewed weakness in the euro against the U.S. dollar.

Emerging markets had a considerably negative reaction to the election of Trump, driven by concerns about his administration's stance on trade and the U.S. dollar's resumed appreciation. We believe there needs to be a major step-up in global economic growth and trade before emerging markets can outperform their developed-market counterparts on a sustained basis. Faster growth in the U.S. helps, but maintenance of open markets and strong trading relationships are also crucial — and the aggressive approach toward trade 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 Trump's surprising electoral victory and the end of U.S. legislative gridlock. There will likely be times in the year ahead when the more worrisome, controversial initiatives pushed by the Trump administration will rattle investor confidence — at which point we would view U.S. equities as attractive. Although equity valuations are elevated in the U.S. versus Europe, Japan and many emerging markets, we are still confident 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

- 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.
- 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.

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