A Resilient Rally

Monthly Market Commentary

February 2017

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- A sense of calm retained its grasp on financial markets in February, as stock-market volatility approached multi-year lows and performance across a broad spectrum of asset classes provided investors with cause for celebration.
- The global equity-market rally carried into February, led at a distance by the healthcare sector. Global fixed-income markets also continued to advance, driven again by 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 higher.

Economic Backdrop

A sense of calm retained its grasp on financial markets, if not politics, in February. Stock-market volatility approached multi-year lows and performance across a broad spectrum of asset classes provided investors with cause for celebration. Stocks rallied in both developed and emerging markets, while corporate and sovereign bond yields generally slid (yields and prices have an inverse relationship). The cost of oil (which is priced in U.S. dollars) resumed an upward trend even as the U.S. dollar re-established its ascent; this points to the conviction of the oil-price rally, as a rising U.S. dollar exerts downward pressure on oil prices.

In the government sphere, the U.K. House of Commons approved the invocation of Article 50 at the beginning of February; but passage ran into an Upper House obstacle as the month drew to a close, with the flotation of an amendment that would guarantee the rights of European Union (EU) citizens to remain in Britain following its withdrawal. The French presidential election consolidated around its centre-left and nationalist-right candidates, with late-February polls showing a tight race. President Donald Trump began February with orders to roll back post-crisis financial regulations, while implementation of his administration's late-January immigration order was blocked, and then denied appeal, by federal judges. National Security Advisor Mike Flynn was forced to resign mid-month after deceiving others in the administration about communication with Russian diplomats. February closed with Trump's first congressional address, which was perceived as an improvement on past speeches.

The Bank of England's Monetary Policy Committee and U.S. Federal Open Market Committee (FOMC) were unanimous in their respective commitments to current policy in early February. The likelihood of a benchmark rate hike by the U.S. central bank at its mid-March meeting appeared to firm during the month, as meeting minutes and Congressional testimony by Federal Reserve Chair Janet Yellen suggested such a move would be appropriate in the near future. Neither the European Central Bank nor the Bank of Japan held monetary policy meetings in February; both retained existing policies during their January meetings.

U.K. construction growth bounced a bit higher in February, while manufacturing growth slid to a three-month trough. However, retail sales volumes improved in February from a disappointing slide in the previous month. Unemployment maintained an 11-year low of 4.8% for the October-to-December period. While year-over-year wage growth slowed to 2.6% in the three months through December, the figure is still growing in real inflation-adjusted terms — outpacing U.K. consumer price inflation, which gained 1.8% in January. The British economy grew 0.7% in the fourth quarter and 2.2% year over year, driven by trade and consumer spending, while business investment was weak.

Eurozone economic activity reached the fastest pace in almost six years, with manufacturing growth accelerating (thanks at least partially to euro weakness) and services growth jumping sharply. The unemployment rate held firm in January at 9.6%; although youth unemployment fell by 0.3% to 20.0%, representing continued marked improvement. Estimates of fourth-quarter gross domestic product (GDP) came in above expectations at 0.5%. Economic sentiment in the region expanded for the fifth consecutive month in February to the highest level in nearly six years, led by improved industrial morale, rising consumer confidence and significantly higher selling-price and household-inflation expectations.

U.S. manufacturing growth unexpectedly jumped in February from already-strong levels, due to broad-based improvement. Personal-income growth accelerated in January, as consumer spending slowed. Initial jobless claims remained low, falling in late February to the lowest level in almost 44 years. This followed a positive January payroll report in which considerably more jobs were added than anticipated despite the unemployment rate increasing to 4.8%.

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Market Impact[1]

Global fixed-income markets continued to advance in February, led again by higher-risk market segments. Emerging market-debt delivered the best performance, with foreign-currency-denominated (external) debt overtaking local-currency-denominated debt (which was January's best performing segment). U.S. high-yield bonds also performed exceptionally well, as did U.S. investment-grade corporate fixed income. Global sovereign securities rebounded in February with a sizeable gain, trailed closely by U.S. Treasurys and mortgage-backed securities. Global non-government debt, U.S. Treasury inflation-protected securities and asset-backed securities delivered comparatively modest returns.

The global equity-market rally carried into February, as reflected by the MSCI AC World Index (Net), led at a distance by the global healthcare sector. Information technology, consumer staples and utilities delivered elevated returns, followed by industrials and financials. Consumer discretionary had a good month, while telecommunications was marginally negative. Materials delivered a small loss compared to energy, which suffered a steep decline. At the country level, Egypt significantly outperformed, followed by India, Turkey and Poland. Taiwan, Brazil and Israel also performed exceptionally well. Russia had the sharpest losses, followed by Colombia, Hungary and Norway.

Index Data (February 2017)

- The MSCI AC World Index (Net), used to gauge global equity performance, advanced by 2.81%.
- The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, increased by 0.47%.
- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index also known as the "fear index", increased in the month from 11.99 to 12.92.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, rose from $52.81 a barrel at the end of January to $54.01 on the last day in February.
- The U.S. dollar strengthened against sterling and the euro, but weakened versus the yen, ending February at $1.24 against sterling, $1.06 versus the euro and at 111.9 yen.

SEI's View

Change is coming in many aspects of U.S. policy, including 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 more questions than answers remain 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, which are 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 by the current administration. We view the biggest impediment to a favourable investment environment in the U.S. as a 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. election. We wonder how long this will be the case, if the U.S. dollar maintains its upward trajectory as we expect. If the FOMC forecast

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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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assumes that real GDP growth will be constrained as the economy approaches full employment, we 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 surprised observers to the upside lately. This simply may reflect some easing of immediate concerns surrounding the U.K. Brexit. Investor attitudes could again turn cautionary ahead of negotiations, which formally begin after Article 50 is invoked (likely at the end of March). The other 27 member countries of the EU may want to 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 more investor uncertainty and angst. In the meantime, improving economic numbers offer a welcome respite. This optimism is reinforced by the renewed weakness of 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 resumed appreciation of the U.S. dollar; but this unfavourable response has since recovered. 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; the Trump administration's likely aggressive approach toward trade 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. We expect the more controversial initiatives pushed by the Trump administration to rattle investor confidence at times in the year ahead — 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 remain 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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