Quarterly Market Commentary:
Presidential Torch-Passing and a Brexit Bookend

First Quarter 2017

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- Anticipation gave way early in the first quarter with the U.S. presidential inauguration, followed by a turbulent acclimation period. The quarter ended with formal notice of Great Britain's intent to leave the European Union.
- Fixed-income markets were unanimously positive in U.S. dollars, propelled by higher-risk market segments. Equity markets advanced for much of the quarter, posting strong performance.
- Until interest rates start to rise at a faster-than-anticipated pace, or the economy shows early signs of entering a recession, we will continue to view equity-market price corrections as buying opportunities.

Economic Backdrop

Anticipation gave way early in the first quarter with January's U.S. presidential inauguration, which was followed by a turbulent acclimation period as the new administration wrestled with the constraints of governing in the face of heavy opposition (from both outside and within President Trump's party), critical media and unrelenting controversy. The quarter ended with what will likely prove to be the beginning of a much more enduring shift: Prime Minister Theresa May's formal commencement of Great Britain's withdrawal from the European Union (EU), setting the stage for several years of negotiations centred on the divorce and then the future relationship between the two areas.

Equity markets advanced globally for much of the quarter, then encountered some resistance in March as Trump's agenda was set back by a scuttled attempt at healthcare reform, leaving investors to wonder whether business-friendly tax and regulatory reforms would be delayed or meet a similar fate. Bond yields generally finished the quarter a bit lower (yields and prices have an inverse relationship), hitting a period high in mid-March before staging a steep retreat; emerging-market yields underwent a notable decline.

The U.S. Federal Reserve (Fed) delivered a widely expected quarter-point interest-rate increase following its mid-March meeting, and maintained its target projection of two additional rate hikes for the remainder of 2017. The turnaround in bond-market yields following the announcement was likely attributable to expectations for a revised Fed projection showing more increases, which did not materialise. The Banks of England and Japan held their respective accommodative monetary policy stances firm during the quarter. The European Central Bank (ECB) also declined to make changes, but confirmed that monthly bond purchases would begin to taper from €80 to €60 billion starting early in the second quarter.

U.K. industrial trends were mixed, with orders for manufactured goods holding through March at recent highs — suggesting that recent strength has levelled off. Construction activity also expanded steadily, albeit quite slowly, throughout the quarter. Retail activity started the quarter on a soft note, but partially rebounded in February and appeared to maintain progress in March. Employment trends continued to brighten — although the most inclusive data is on a significant lag — and average year-over-year earnings slid for the third consecutive report. Economic growth expanded in the fourth quarter by 0.7% and 1.9% year over year.

Eurozone manufacturing activity expanded at an accelerating pace for the seventh-straight month, hitting its highest growth in almost six years; the services sector told a similar story. The jobless rate continued to fall through February, to 9.5%, with elevated youth unemployment falling at double the pace of the broad labour market. Economic sentiment began the first quarter continuing a theme of gradual improvement, then levelled off, albeit at the highest levels since early 2011. Consumer prices capped a five-month climb at 2.0% year over year in February, then retreated according to preliminary March data. The eurozone economy expanded by 0.4% during the fourth quarter a pickup from the previous quarter.

U.S. retail sales growth was low during the first quarter, but strong on a seasonal basis given the outright contractions that tend to take place following the holidays, which is consistent with the historically high consumer sentiment reflected in first-quarter surveys. Consumer prices continued a slow upward trend, with core personal consumption expenditures (the Fed's preferred inflation gauge, which excludes food and energy given their volatility) reaching a 1.8% year-over-year increase in February. Average earnings growth continued apace, but real income growth showed modest signs of inflationary erosion. The February unemployment rate fell back to 4.7% in concert with a rising labour force participation rate. Fourth-quarter economic growth totalled an annualised 2.1%, which was a good bit below the third quarter's pace.

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Market Impact[1]

Fixed-income markets were unanimously positive during the first quarter, propelled by higher-risk market segments. Local-currency-denominated emerging-market debt led by a considerable margin as the U.S. dollar weakened, followed by foreign-currency-denominated (external) emerging-market debt, U.S. high-yield bonds, and global sovereign securities. Global non-government debt, U.S. investment-grade corporate fixed income, and U.S. Treasury inflation-protected securities (TIPS) performed well. U.S. Treasurys, asset-backed securities, and mortgage-backed securities also delivered positive performance.

Global equity markets advanced for much of the quarter, according to the MSCI ACWI Index (Net), posting a strong performance. Information technology was far-and-away the top-performing global sector, while energy delivered the only loss. Telecommunications, while positive, lagged most sectors, and financials underperformed by a bit as well. Latin America and Asia Pacific were the best-performing regions, although Poland and India had the best country-specific returns. Russia delivered the largest loss, followed by Greece, and Hungary was modestly negative.

Index Data (First Quarter 2017)

- The MSCI AC World Index (Net), used to gauge global equity performance, rose by 6.91%.
- The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, advanced by 1.76%.
- 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,” decreased in the quarter as a whole, moving from 14.04 to 12.37.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, moved from $53.72 a barrel at the end of December to $50.60 on the last day in March.
- The U.S. dollar weakened against the world’s major currencies, ending March at $1.25 versus sterling, $1.07 against the euro and at 111.43 yen.

SEI’s View

There’s no denying that the “Trump reflation” trade began to fade toward the end of the first quarter as healthcare reform efforts ran up against internal divisions between Congressional Republicans, complicating the coming debate over tax reform. We expect the U.S. economy will continue to expand, although a step-up in growth will hinge on how successfully the Trump Administration pushes through pro-cyclical legislation and rule changes.

We are witnessing the strongest synchronised advance in European economic data across developed and emerging economies since 2009-10. As a major exporting region, broad improvement in global activity is good news. The ECB will likely be slow to ease off the gas pedal, despite all the talk of tapering its bond buying, as it does not want to repeat the mistake it made in 2011 when it prematurely hiked interest rates.

In France, a path to electoral victory has opened for independent-candidate Emmanuel Macron. His economic reform proposals seem less extreme and more in keeping with the sensibilities of the average French voter, and even a modest program toward a more business-friendly environment and flexible labour market would represent a step in the right direction. Most important, the threat of an upset victory by Marine LePen of the populist National Front now appears much reduced.

Investors remain nervous about Europe’s periphery; Italian bond yields, for example, are still near their highest level over the past two years in absolute terms and at three-year highs relative to German bunds. Although progress is being made in recapitalising Italy’s banking system and writing off bad debt, it will be a multi-year process before it is on sounder footing.

Prime Minister Teresa May has started the clock on the United Kingdom’s exit from the EU. Like many other observers, we have been surprised at how well the economy has performed. Although inflation pressures seem to building, it doesn’t look as if the Bank of England is in a rush to tighten policy. The uncertainties surrounding Brexit are too great.

Hopes for a soft Brexit have faded in recent months as May’s government seeks severe limits on the free movement of people from the EU and takes back sovereignty from the European Court of Justice. The EU, meanwhile, wants to impose

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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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an exit fee of up to €60 billion — an estimate of the net liabilities owed by the U.K. — before substantive discussions have even begun. It is a bad start to a challenging process.

Emerging equity and bond markets swooned in the immediate aftermath of Trump's November victory in response to the Administration's aggressive trade stance, but have since managed to climb a big, beautiful wall of worry. The MSCI Emerging Markets total return index is in new cycle-high territory in both local-currency and dollar terms. In similar fashion, emerging market bond yields have declined, with option-adjusted spreads reaching multi-year lows versus U.S. Treasuries.

Investors seem to be taking a more relaxed view of the future, assuming that the Trump Administration's bark is much worse than its bite. That said, investors should keep in mind that President Trump has the final say, and he seems intent to deliver on his promise to reduce import competition and bring manufacturing capacity back to the U.S.

Back during the last synchronised global expansion following the 2007-09 recession, China led the way to higher economic ground with a debt-infused boom, while the United States played an important secondary role. This time, the focus has been on enthusiasm for the Trump Administration's tax and regulatory reform efforts. Now, China is in the role of best-supporting actor on the world stage.

The Chinese economy is responding to the fiscal and monetary stimulus the government set in motion in 2015, a time when the country's financial markets were going through a period of intense stress. This latest expansion is much lower than the peak rates reached in 2009 and 2013, but strong enough to spark a rebound in growth in some more reliable measures of economic activity.

Imports have risen in the past year as China continues the process of shifting its economic model away from an export/industrial focus to a consumer/services one. Exports to the U.S. have risen, however, even as they decline modestly to other regions of the world. China remains by far the single biggest contributor to the U.S. merchandise trade deficit. We are concerned that the Trump Administration will still decide to name China a currency manipulator or levy punitive tariffs. A trade war, combined with geopolitical tensions over China's island-building, could derail an otherwise promising global macroeconomic environment.

We anticipate that the Chinese government will not make too many waves economically or politically into the run-up to the 19th Communist Party Congress in October, when the country's leadership will be reshuffled and Chairman Xi Jinping will presumably consolidate his hold on power. And so, we expect to see a continuation the country's steady-to-better growth.

In our opinion, the valuation of U.S. equities is a moderate concern at this point. Granted, economic, earnings and political disappointments are not as easily ignored now as they might be at lower valuation levels. Nonetheless, until interest rates start to rise at a faster-than-anticipated pace, or the economy shows early signs of entering a recession, we will continue to view price corrections as buying opportunities. In the meantime, the world economy appears to be on the mend. Geographically diversified equity portfolios that have had a tough time keeping up with the S&P 500 Index may begin to out-perform.

In fixed-income markets, we expect the normalisation of interest rates to higher levels to proceed at a rather sedate pace. For the most part, inflation is not the global economy's biggest problem. It is the lack of growth. That seems to be changing, but we do not look for aggressive tightening by central banks. The Fed may be leading the way, but until inflation becomes a bigger problem than it is now, even the U.S. central bank is likely to tread carefully. This should limit the danger of a debacle in the bond markets. It also provides a favourable backdrop for an equity market that continues to defy the naysayers.

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.
- Macroeconomic: Macroeconomic refers to the broad economy of a country or region, or the global economy.
- Mortgage-backed securities: Mortgage-backed securities are made up of multiple mortgages packaged together into single securities. These can comprise commercial or residential mortgages. Agency means that the debt is guaranteed by a government-sponsored entity, while non-agency means that it is not.
- Option-adjusted spreads: Option-adjusted spreads refer to a calculation used to help determine price differences

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between similar products that allow different embedded options.

- 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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