Economic Overview
Quarterly Investment Review

First Quarter 2017

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Point of View

Economic Outlook

The Outlook: Climbing a Big, Beautiful Wall of Worry

The good news

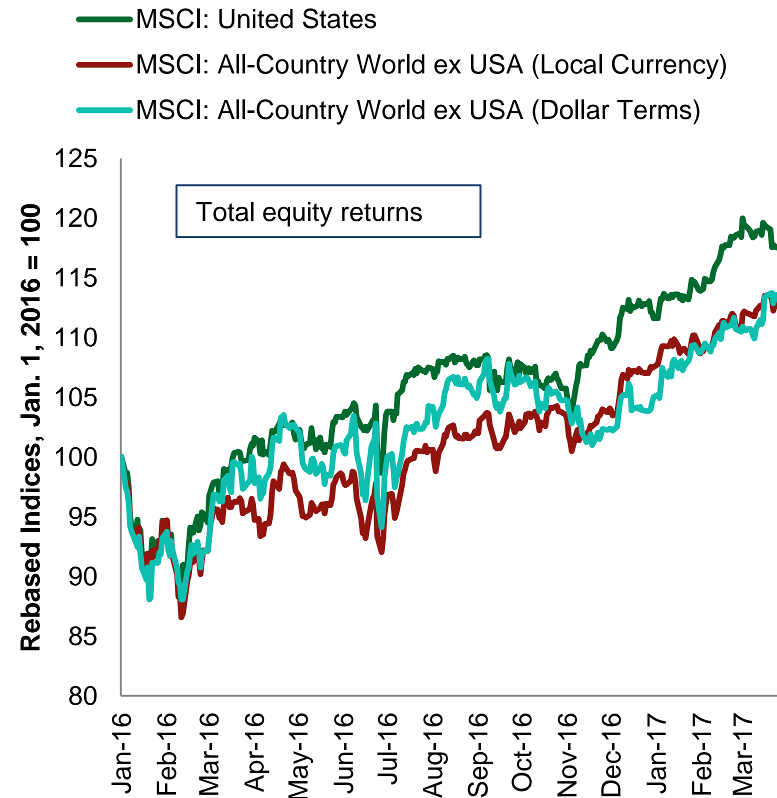
- Despite the Trump Administration's rocky start, measures of confidence continue to soar.
- There are signs that a synchronized global expansion is underway for the first time since the initial rebound from recession in 2009-10.
- Europe's economic outlook is brightening and unemployment is coming down steadily even in the periphery countries of Spain and Italy.
- Emerging markets have rebounded sharply in response to signs of improving global economic growth, firmer commodity pricing and the hope that the Trump Administration's trade policies will not be as protectionist as its rhetoric.
- Equity valuations are moderately concerning in the U.S., but can still be justified against a backdrop of low inflation and interest rates amid improving growth prospects. That said, international equity diversification makes tactical sense

The bad news

- The so-called "hard data" that measure actual economic activity in the U.S. have not been nearly as buoyant as the survey data on confidence and expectations. The extent of U.S. tax reform now is being questioned after the failure to repeal and replace the Affordable Care Act.
- As fears of deflation recede, investors will focus on the central bank actions, including rising interest rates begin (U.S.) and tapering of quantitative easing programs (Europe).
- Populist politics will continue to be a concern in Europe, although the worst fears have not come to pass. Italy, however, remains the weak link and the greatest source of concern within the Eurozone.
- The economic disruption posed by Brexit should come into better focus in 2017 as negotiations begin.
- We remain concerned that trade-war fears will flair up again as President Trump seeks to reduce imbalances with China, Mexico and Germany.

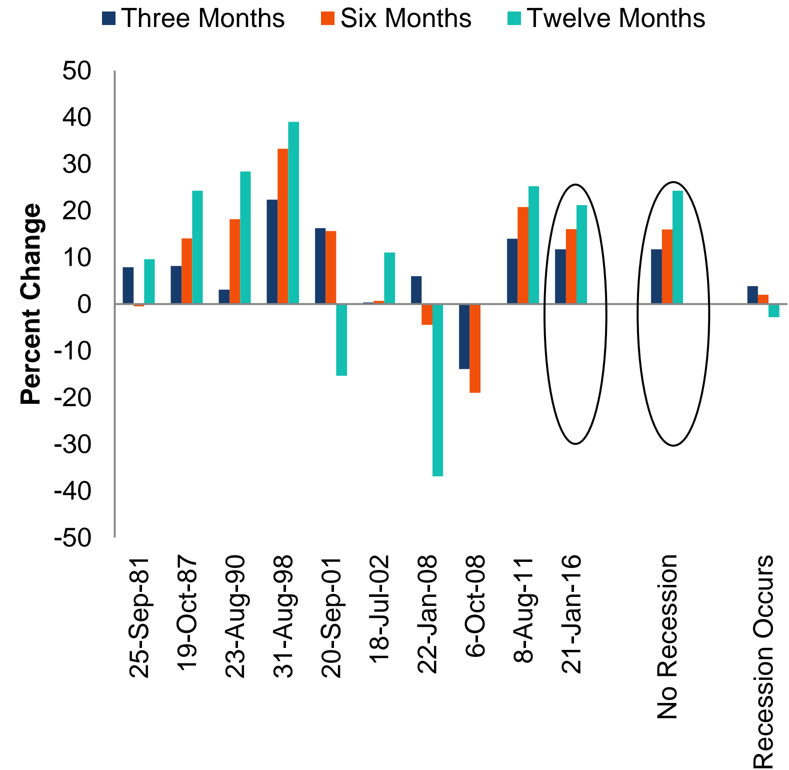
Don’t worry, be happy

- The MSCI USA Index has advanced about 5% in dollar terms since the end of last year, and is only 2% below its closing high reached on March 1.
- Since the day after the election (November 10), the Index has logged a total return of 9%.
- However, since the election, the MSCI USA Index is slightly lagging the rest of the world, in both dollar and local-currency terms, as measured by the MSCI All-Country World Index.



Being bullish when others are bearish

- We leaned against the prevailing bearishness in January 2016, noting that the selling pressure in equities had hit an extreme — an extreme that typically leads to a sharp rally over the next three, six and twelve months.
- The chart highlights the price-only performance of the S&P 500 from the time the percentage of stocks trading above their 200-day moving average (MA) initially falls below 15%. The sharper and more prolonged the stock correction, the lower the percentage of stocks still trading above their 200-day MA.
- The price appreciation over the last three, six and twelve months closely matched the median performance for all the times over the previous 36 years when stocks were oversold but an economic recession was avoided.

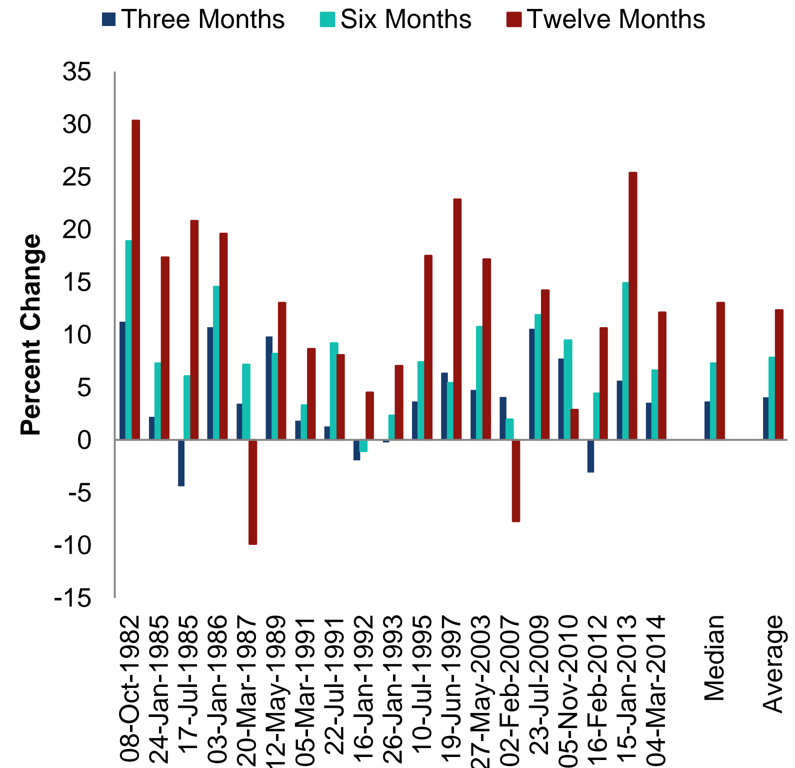


Source: Ned Davis Research, Standard & Poor's, SEI

Figure represents price change in the S&P 500 price-only index from the time when the number of stocks above their 200-day moving average initially falls below 15.0%

Bulls like to stay bullish

- The economic and stock-market backdrop is now considerably changed. The percentage of stocks trading above their 200-day moving average is approaching 80%. Is that a sign of an overbought market?
- In the past 36 years, we have seen almost 20 occasions when the percentage of stocks trading above their 200-day moving average exceeded 80%. Most of the time, the bull market in equities continued.
- That's because bull markets tend to roll over into bear markets gradually.
- Over the 19 occasions shown in the chart, equity prices declined only twice in the twelve months following the initial breach to the upside of the 80% mark.

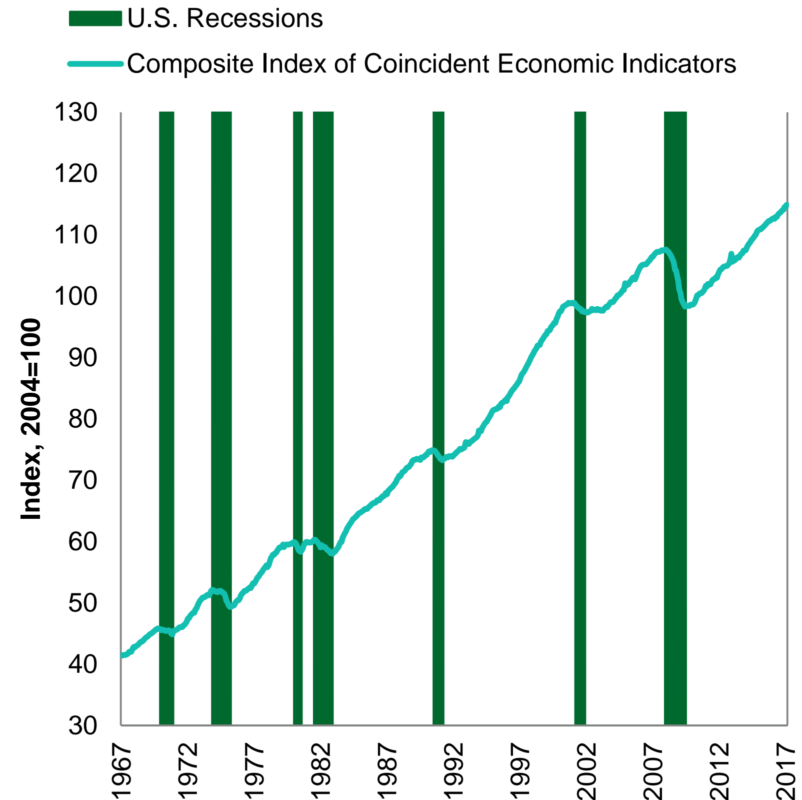


Source: Ned Davis Research, Standard & Poor's, SEI

Figure represents price change in the S&P 500 price-only index from the time when the number of stocks above their 200-day moving average initially rises above 80%

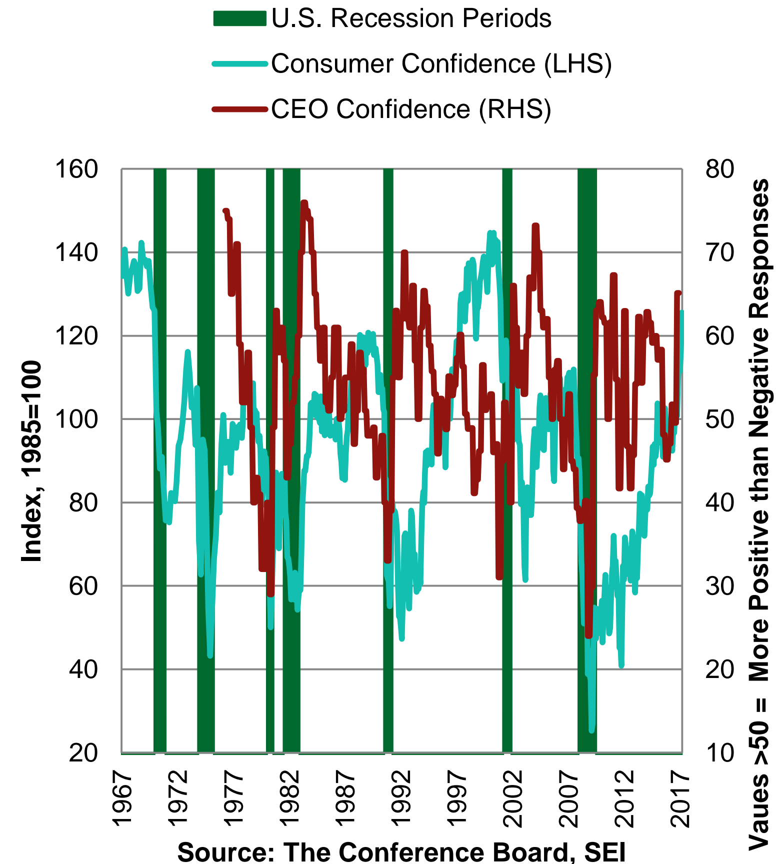
A steady economic ship

- The Conference Board's composite index of four economic indicators serves as a good proxy for the relative health of U.S. business activity.
- The index includes four widely-watched indicators: the number of employees on nonagricultural payrolls, personal income less transfer payments, industrial production, and the volume of manufacturing and trade sales.
- The index continues to climb in steady fashion, even though the industrial production component has been flat for more than a year.
- There's not much sign of a significant acceleration in the rate of growth, but there is certainly no indication that the economy is losing altitude.



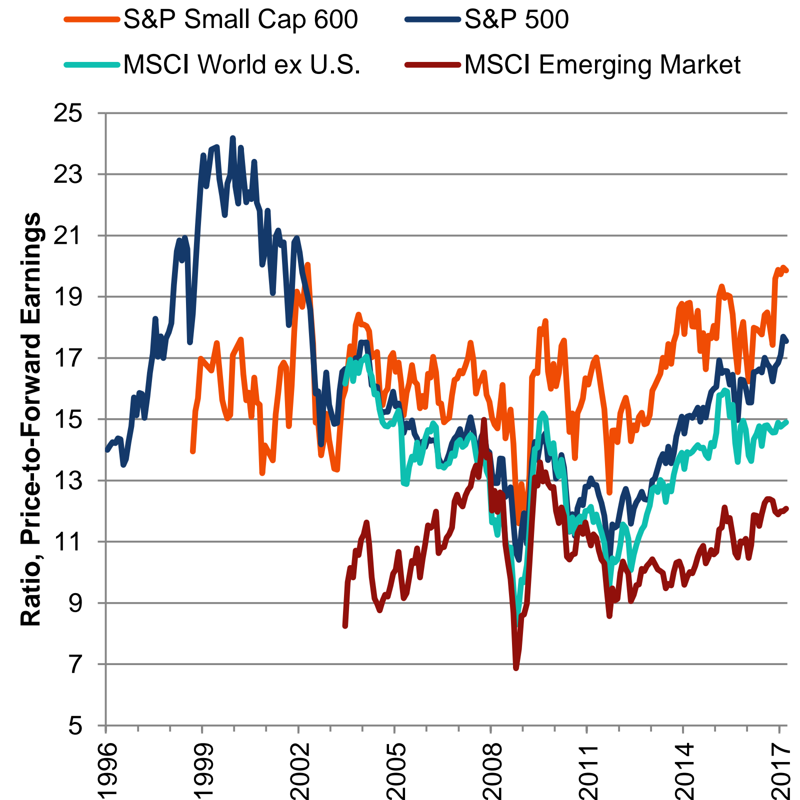
Rational exuberance?

- Most eye-catching, however, has been the steep rise in confidence.
- Both business and consumer confidence have surged in the aftermath of the election on hopes that the Trump Administration will push for changes in laws and regulations that will help reduce the costs of doing business, increase household incomes and employment and enhance the availability of credit.
- A pessimist would point out that consumer confidence already has reached a level that has often preceded the onset of recession.
- We would counter with the observation that business confidence tends to deteriorate as the expansion ages. By the time a recession begins, CEOs are already cautious. That sort of caution is not in evidence at this time.



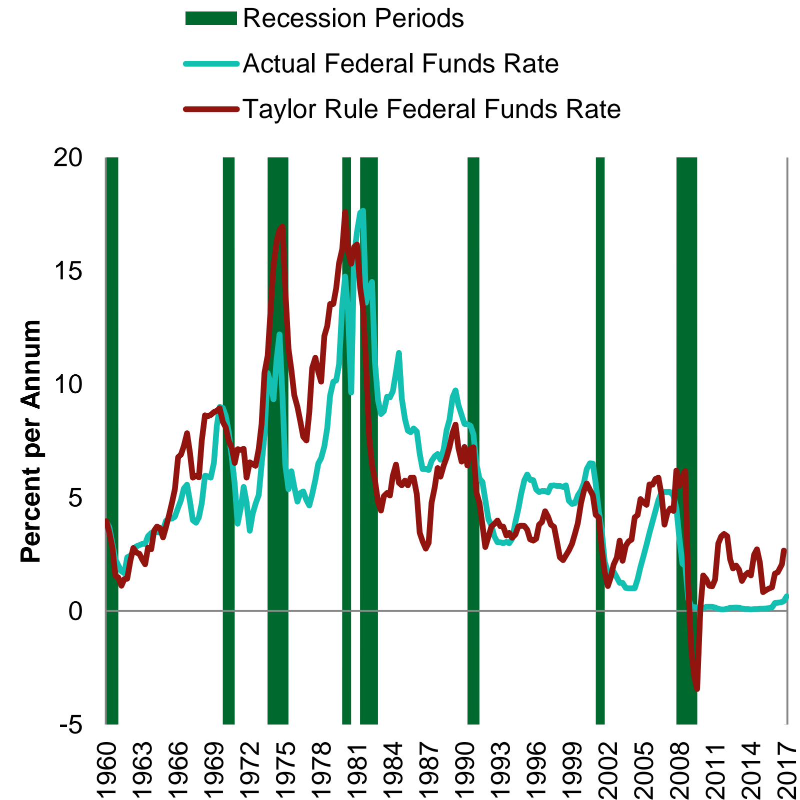
A bull market in valuation

- Stock-market investors are anticipating better times ahead.
- Forward earnings are rising more rapidly than actual earnings, while multiples on those forward earnings have expanded sharply in recent months.
- While we agree that the U.S. equity market is less attractive on a valuation basis than it used to be, we believe that it would be a mistake to discount the momentum that U.S. equities still enjoy owing to the promise of accelerating revenue and earnings growth.
- Nonetheless, one can make a good argument nowadays that it's time to fade U.S. equities and tactically overweight global equity markets. That doesn't mean that U.S. equities are dangerously overvalued.



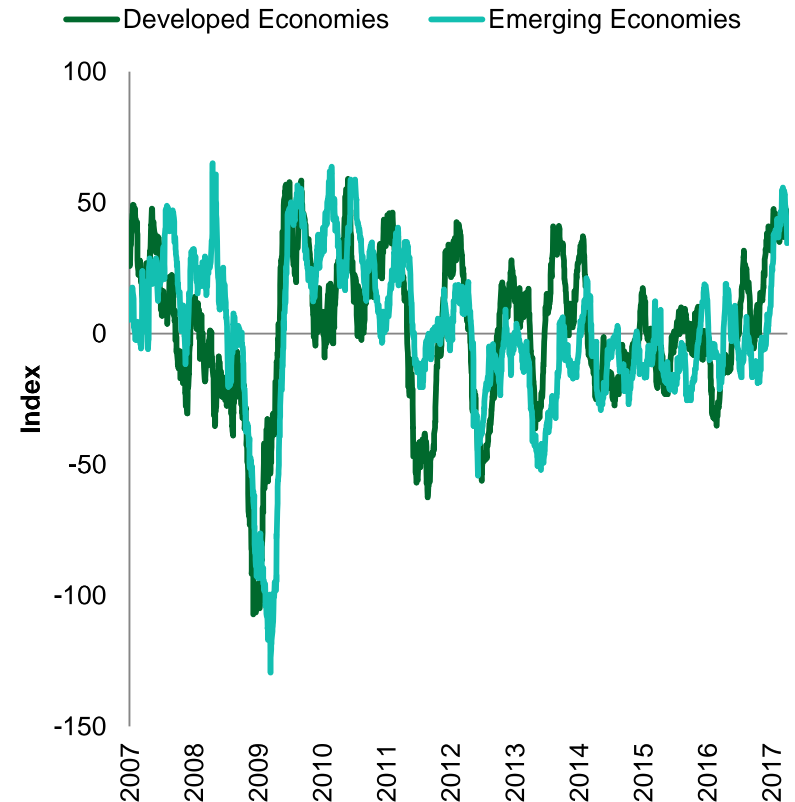
Will Taylor rule?

- The Taylor rule (named after Stanford economist John Taylor) provides some insight into where the Federal funds rate "should" be versus where it is.
- This rule is based on three factors: actual versus targeted inflation levels, actual employment or output versus an estimate of full-employment levels, and the level of short-term rates thought to be consistent with full employment and a steady inflation rate.
- The Taylor Rule currently indicates that the Federal funds rate should be near 2.75% compared to the current 0.75%-to-1.00% range that was approved in mid-March.
- The federal funds rate target currently suggested by the Taylor Rule is very close to the Federal Open Market Committee's forecast of the long-run equilibrium rate of 3%.



Synchronized improvement

- At the beginning of the year, we noted that economic growth in Europe was surprising to the upside.
- The data are still surprising in that direction. Indeed, we are witnessing the strongest synchronized move to the upside in the economic data across developed and emerging economies since 2009-10.
- As in the U.S., the improvement is more notable in the “soft” economic data (surveys of purchasing managers, business sentiment and consumer confidence, for example) than in the “hard” data (such as retail sales, construction and industrial production).
- As a major exporting region, this synchronized improvement in global activity is good news for the European outlook.

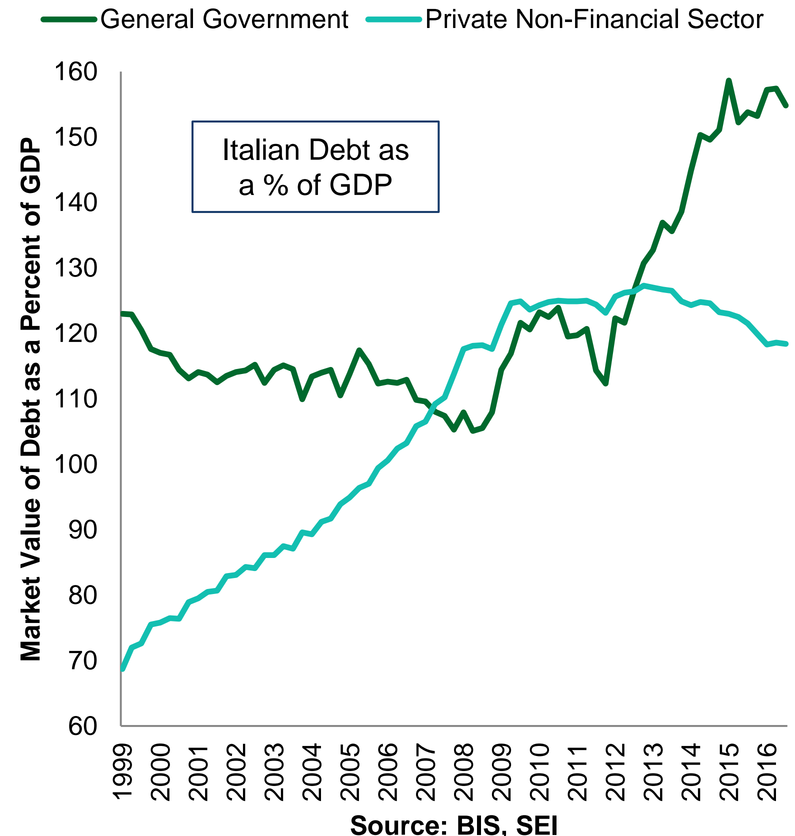


Citigroup Economic Surprise Index

The Economic Surprise Index is defined as the weighted historical standard deviations of data surprises (actual releases vs. Bloomberg survey median).

Italy: A leaning tower of debt

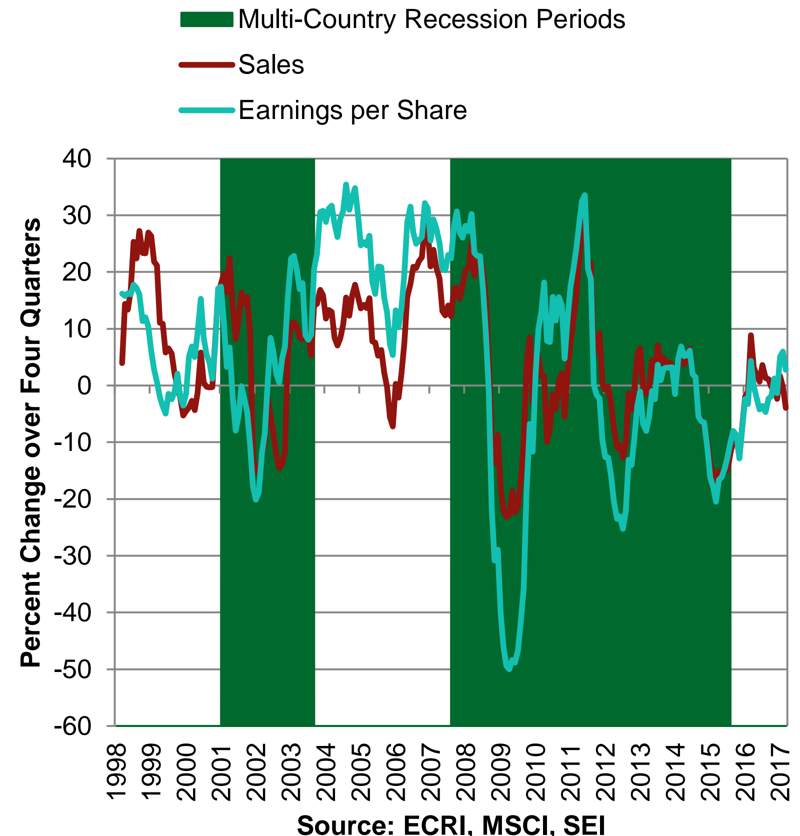
- We harbor concerns about Italy. Although progress is being made in recapitalizing its banking system, it will be a multi-year process before it is on sounder footing.
- While the debt burden of Italian private non-financial debt has eased from a peak in 2013, the market value of Italian general government debt has continued to climb. This is an unsustainable trajectory.
- The continuing debt overhang will serve to constrain the flow of credit to the private sector, and the government will have no choice but to pursue further austerity.
- We are assuming that Italy will not leave the eurozone anytime soon. But if there is a weak link in what appears to be an improving European economic trend, it is surely Italy.



Data as of 12/31/16

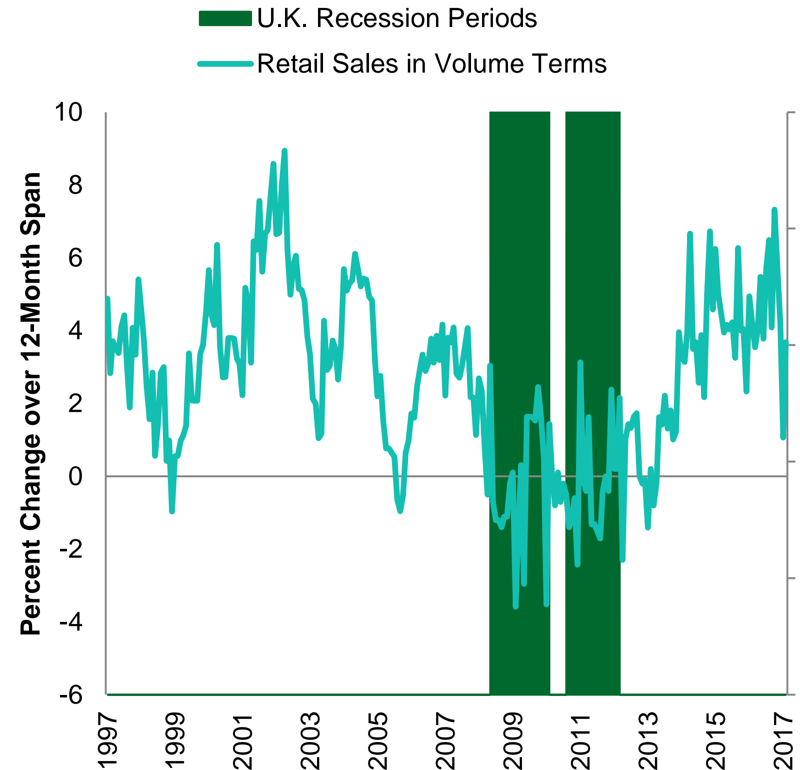
The eurozone takes a recession recess

- The modest pick-up in eurozone growth has helped push the year-over year change in earnings into positive territory.
- Europe's companies are saddled with high fixed costs. As a result, earnings tend to drop more sharply during economic slowdowns but also rebound more sharply during upturns versus the up-and-down cycles in the U.S. and other developed countries and regions.
- If the global economy is indeed getting traction, European companies should benefit more than most as a result of this operational leverage.



Spending a tad lower lately on High Street

- When the Brexit referendum occurred last June, we figured the sharp decline in sterling would cushion the negative economic reaction that would result from the uncertainty.
- Like many other observers, we have been surprised at how well the economy has performed. Inflation-adjusted gross domestic product rose 2% last year.
- However, there are increasing concerns that incomes are starting to lag in real terms as inflation picks up as a result of the currency depreciation.
- Retail sales have turned notably weaker over the past couple of months, while consumer prices are swinging higher. Despite this rise, the Bank of England had held its base rate steady, following a 50 basis-point cut in the aftermath of the Brexit vote.

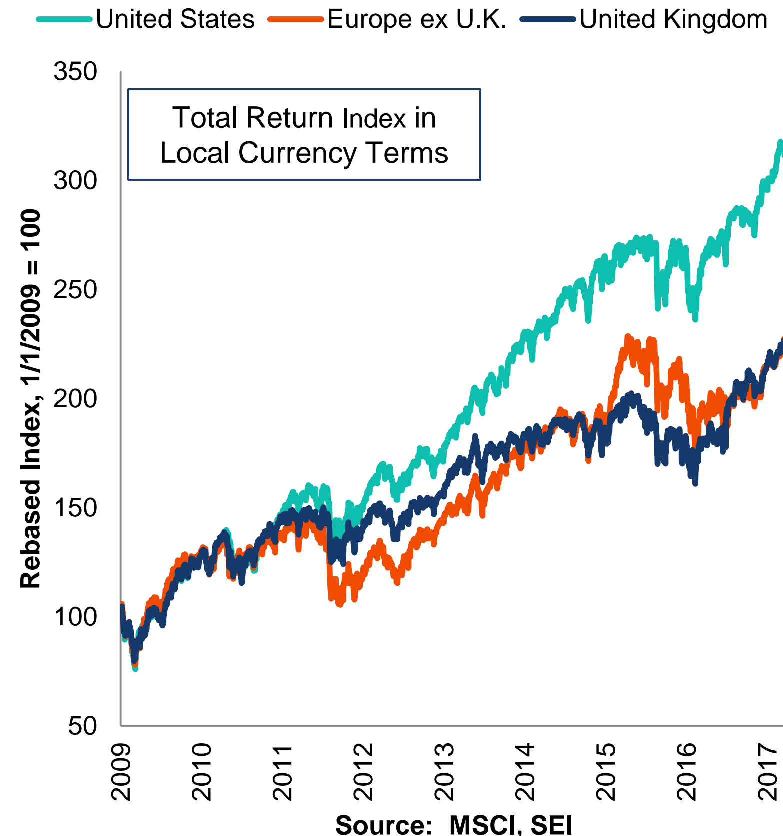


Source: Economic Cycle Research Institute, U.K. Office of National Statistics, SEI

Data as of 12/31/16

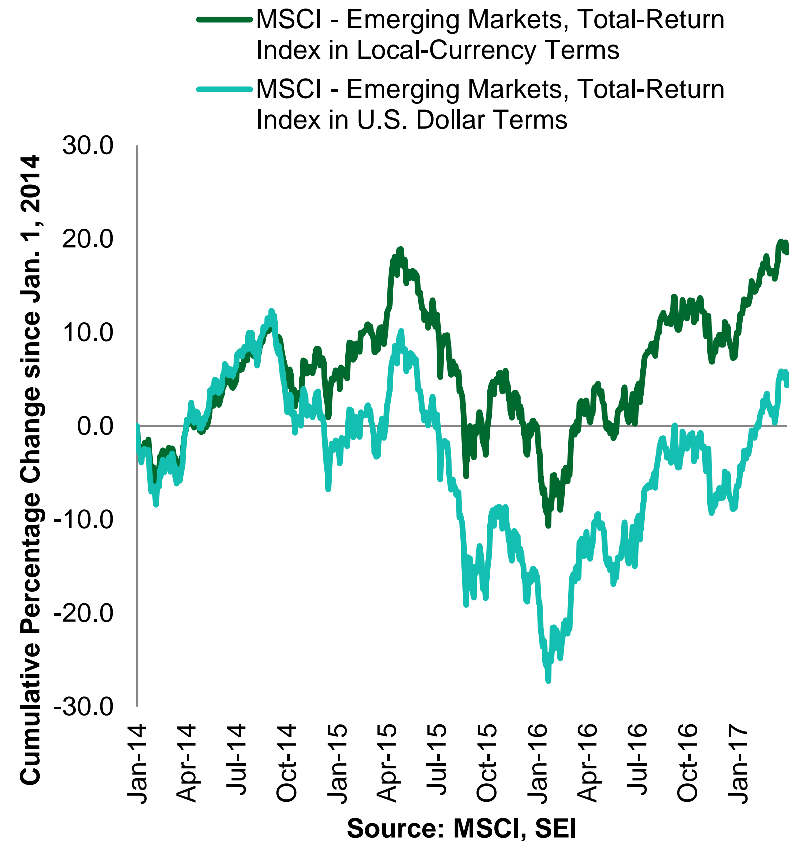
The bull market eight years on

- Since the Brexit vote last June, the UK stock market, as measured by the MSCI United Kingdom total-return index, has outperformed the rest of Europe on a local-currency basis, but has underperformed from the perspective of a UK investor in sterling terms owing to the pound's sharp depreciation against other European currencies.
- That noted, a 24% appreciation since the day of the vote in UK equities is a stunning performance.
- Since the beginning of 2009, the UK and the rest of Europe have logged a cumulative gain of 125% in local-currency terms. This total-return performance badly lags the 210% cumulative appreciation achieved by U.S. equities.



Emerging no longer submerging

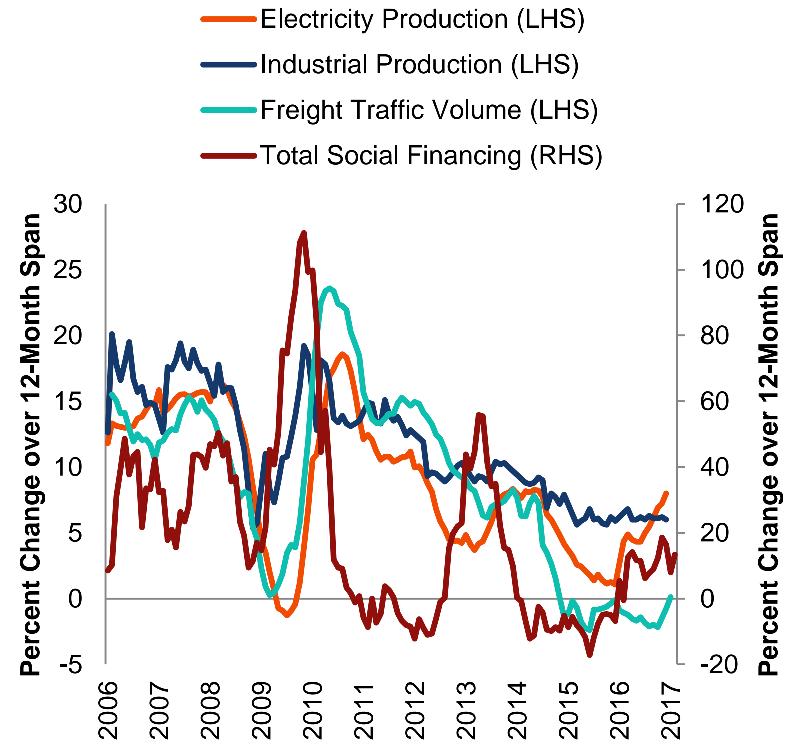
- Emerging equity and bond markets swooned in the immediate aftermath of Donald Trump's election victory in November. The administration's aggressive trade stance included picking a fight with Mexico over NAFTA and appointing advisors well-known for their protectionist views.
- Emerging markets have managed to climb this big, beautiful wall of worry, nonetheless. The MSCI Emerging Markets Index is in new cycle-high territory in both local-currency and dollar terms.
- 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.



Source: MSCI, SEI

The dragon stops dragging

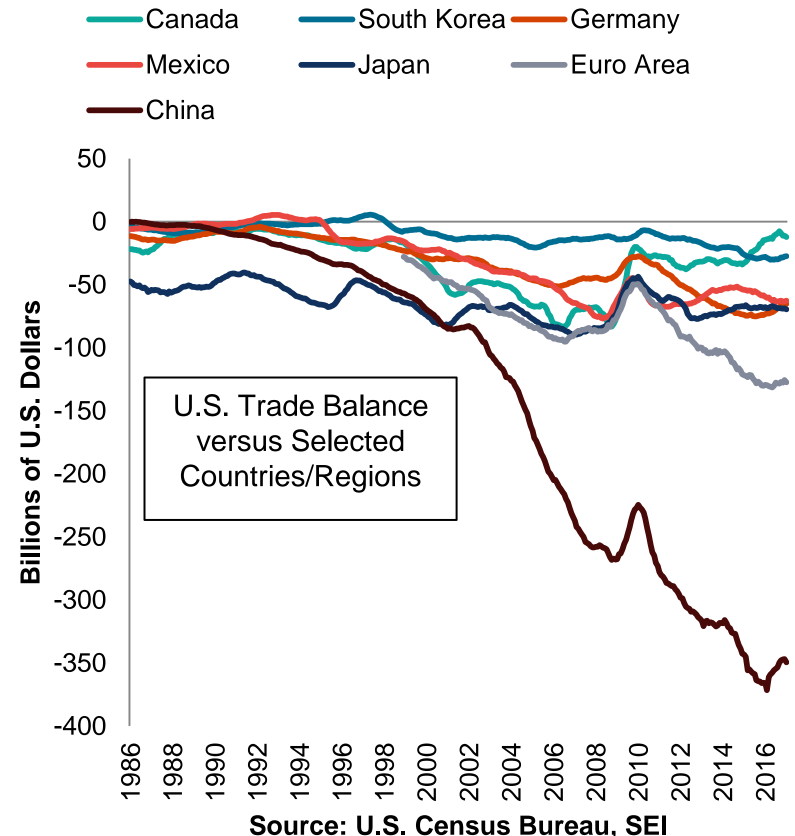
- The Chinese economy is responding to the fiscal and monetary stimulus the government set in motion in 2015, a time when the country's financial markets were going through a period of intense stress.
- This latest expansion is much lower than the peak rates reached in 2009 and 2013, but strong enough to spark a rebound in growth in some of the more reliable measures of economic activity such as freight traffic and electricity production.
- We note that industrial production in China has not yet begun to accelerate, remaining near a 6% annual rate. We think this lagging performance reflects the government's efforts to shut down some of the more uneconomic mining and manufacturing operations that have been the source of excess global supply.



Source: National Bureau of Statistics of China, People's Bank of China, OECD - Main Economic Indicators, SEI

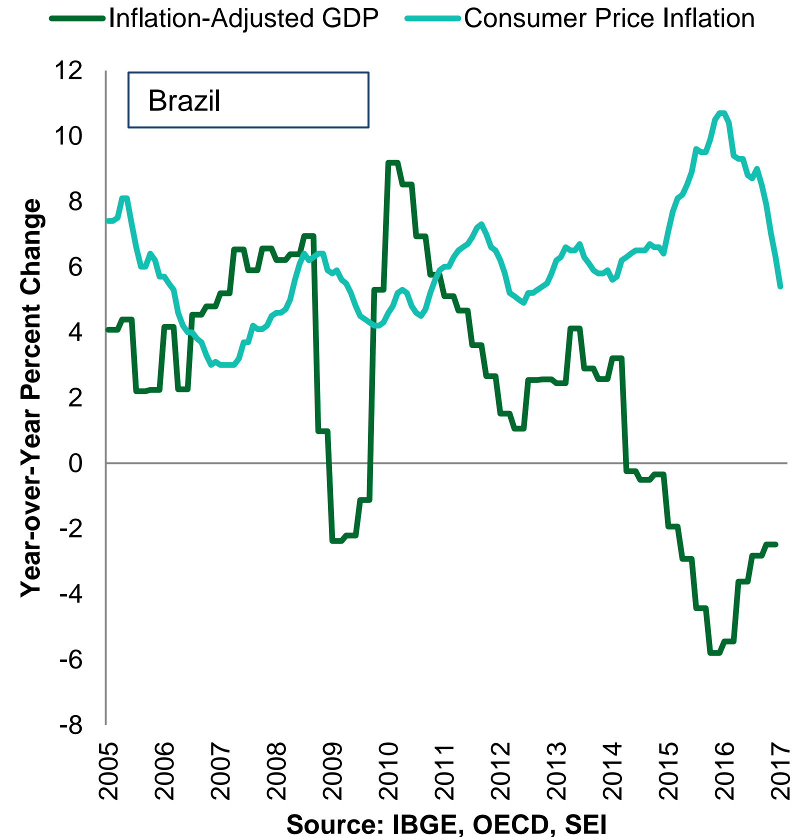
When it comes to trade, Trump sees red

- China remains by far the single biggest contributor to the U.S. merchandise trade deficit.
- In view of the huge trade imbalance versus China, we remain concerned that the Trump Administration will still decide to name China a currency manipulator and/or levy punitive tariffs on industries and goods.
- A tit-for-tat trade war, combined with geopolitical tensions over China's island-building, could derail an otherwise promising global macroeconomic environment.



Slow recovery in Rio

- Brazil's economy remains in recession, although the year-over-year declines in real gross domestic product have been decelerating.
- The Brazilian trade surplus has reached record levels in recent years, running at a sustained pace that is roughly twice the previous high-water mark seen during the 2004-06 period.
- The Brazilian real's sharp recovery against the dollar over the past year also has helped to push the rate of inflation down to almost 5% on a year-over-year basis. Just a year ago, the inflation rate was close to 11%.
- As a result of this improvement, interest rates have begun to slide across the yield curve. Policy rates have been cut by two percent points by the country's central bank. At 12%, however, they remain well above the inflation rate.



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QIR: Important information

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CONTINUED OVERLEAF

QIR: Important information (continued)

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- 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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