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MONTHLY MARKET COMMENTARY | MAY 2018

# Trade Tensions Test Alliances

## Monthly Snapshot

- The Trump administration cited national security concerns as it imposed steel and aluminium tariffs on the EU, Canada and Mexico in late May; this came after the expiration of a two-month waiver that had been extended to these major trading partners, which have traditionally been US allies.
- The 10-year US Treasury yield touched a seven-year high during the month (yields move inversely to prices), and West Texas Intermediate crude-oil prices climbed to their highest level since late 2014 in US dollar terms.
- The synchronized global expansion is still alive and well. Earnings have continued to climb briskly around the world.

## Economic Backdrop

The swearing in of Italy's Prime Minister Giuseppe Conte—a relative newcomer to politics—signalled continued viability of the euro-sceptic coalition, which formed from the two populist parties that won the country's March election. Financial markets were rattled in May by the anti-EU implications of the new Italian government taking shape, then again as rejection of the coalition's first choice for economy minister seemed to set the stage for another round of elections and associated delays. Spain's government also experienced turnover as centre-right Prime Minister Mariano Rajoy suffered a no-confidence vote and was replaced by socialist leader Pedro Sanchez at the beginning of June.

A Brexit proposal by UK negotiators for Northern Ireland to have joint EU and UK status was floated in an effort to avoid hard borders, but did not appear to garner much support. Pressure intensified on the Labour Party to agitate for a second referendum once the Brexit deal is finalised, with the expectation that the 'Remain' campaign will fare better when concrete details are available.

The Trump administration cited national security concerns as it imposed steel and aluminium tariffs on the EU, Canada and Mexico in late May; this came after the expiration of a two-month waiver that had been extended to these major trading partners, which have traditionally been US allies. All three responded with rebukes and retaliatory measures in the form of tariffs on US goods; additionally, the EU opened a formal case with the World Trade Organisation. The Chinese government appeared to step back from assurances that it would underwrite increased purchases of American products as part of negotiations to reduce its trade imbalance with the US, bristling at re-proposed plans of the Trump administration to apply China-specific tariffs.

The 10-year US Treasury yield touched a seven-year high in May before settling somewhat lower by the end of the month. West Texas Intermediate (WTI) crude-oil prices climbed to their highest level since late 2014, as the US backed out of a multi-party nuclear disarmament agreement with Iran and re-imposed economic sanctions; prices ultimately retreated sharply on reports that the Organization of the Petroleum Exporting Countries and Russia may reach an agreement to raise output. The spread between prices for Brent crude (associated with the European market) and WTI (associated with the US market) widened by the most since early 2015. US stocks were

## Key Measures: May 2018

| | | |
|---|---|---|
| **EQUITY** | | |
| Dow Jones Industrial Average | 1.41% | ↑ |
| S&P 500 Index | 2.41% | ↑ |
| NASDAQ Composite Index | 5.50% | ↑ |
| MSCI ACWI Index (Net) | 0.12% | ↑ |
| **BOND** | | |
| Bloomberg Barclays Global Aggregate Index | -0.76% | ↓ |
| **VOLATILITY** | | |
| Chicago Board Options Exchange Volatility Index<br>PRIOR MONTH: **15.39** | 15.43 | ↑ |
| **OIL** | | |
| WTI Cushing crude oil prices<br>PRIOR MONTH: **$68.57** | $67.04 | ↓ |
| **CURRENCIES** | | |
| Sterling vs. US dollar | $1.33 | ↓ |
| Euro vs. US dollar | $1.17 | ↓ |
| US dollar vs. yen | ¥108.65 | ↓ |

Sources: Bloomberg, FactSet, Lipper

largely alone among developed markets as they finished May in positive territory; Europe was considerably negative, while the UK was also down. Emerging-market equities performed even worse, especially in Latin America. The US-versus-everywhere-else divide extended to performance in the fixed-income universe as well.

The Bank of England's Monetary Policy Committee held firm in May, while the European Central Bank and Bank of Japan had no meeting on monetary policy during the month. The US Federal Reserve (Fed) took no new monetary policy actions following its early-May meeting, but asserted willingness to let inflation run above its 2% target in the short-term. The Fed met late in the month to begin unwinding parts of the Volcker Rule, a regulation imposed by the US government after the financial crisis that sharply limited banks from proprietary trading.

UK manufacturing growth accelerated in May following the prior month's trough, while construction gains were unchanged. Consumer prices increased by 0.4% in April, touching recent monthly highs, but year-over-year inflation dropped to 2.4%. The jobless claimant count edged up to 2.5% in April, while the unemployment rate for the January-to-March period held at 4.2%; average year-over-year earnings growth slid to 2.6% for the three-month period ending March. First-quarter economic growth dropped to 0.1%, the slowest quarterly pace in more than five years, and to 1.2% year over year.

Eurozone manufacturing growth continued to slide in May from its December peak, settling to its lowest level since early 2017; services-sector activity appeared to follow a similar trajectory, based on preliminary data for May. The unemployment rate fell to 8.5% in April after an upward revision to the March figure. A preliminary economic-growth estimate was recorded at 0.4% for the first quarter and 2.5% year over year; both numbers were 0.2% below their respective levels in the prior quarter.

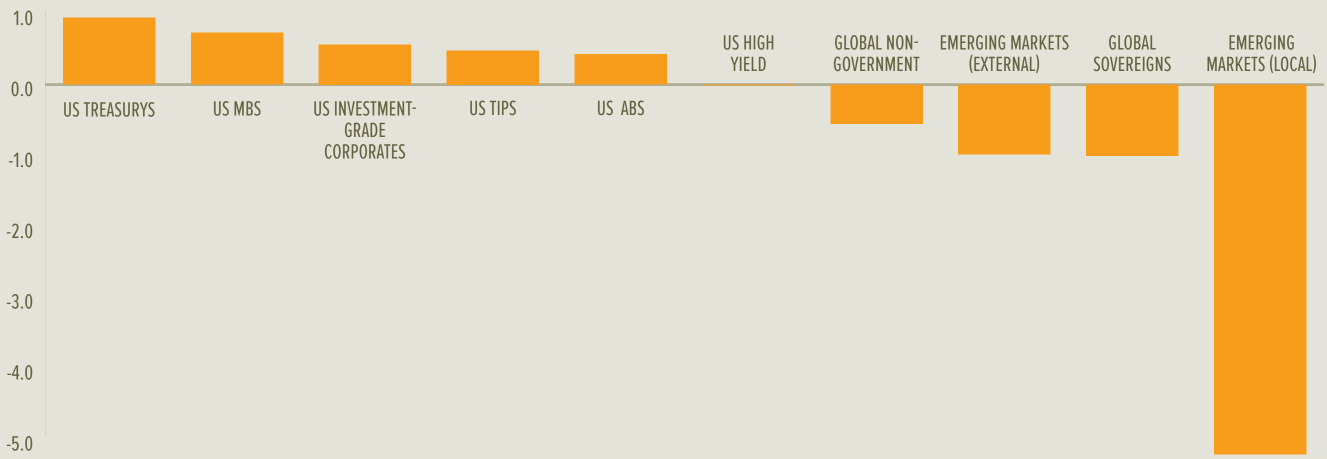
Reports of US manufacturing growth were mixed but generally strong. The unemployment rate ticked down to 3.8% in May, the labour-force participation rate declined, and average hourly earnings improved.

## Major Index Performance in May 2018 (Percent Return)


Sources: FactSet, Lipper. See "Corresponding Indexes for Major Index Performance Exhibit" in the Index Descriptions section for more information.

**All references to performance are in US dollar terms unless otherwise noted. See Standardised Performance for more information.**

## Fixed-Income Performance in May 2018 (Percent Return)




Sources: FactSet, Lipper. See "Corresponding Indexes for Fixed-Income Performance Exhibit" in the Index Descriptions section for more information.

Consumer spending increased in April as consumer price measures remained near the Fed's inflation target. A second estimate of first-quarter economic growth edged down to an annualised 2.2% rate.

## Our View

We suspect the bull market in US equities is somewhere near the beginning of the end, while it may be somewhat closer to the end of the beginning in other countries. To be clear, we are not saying that the bull market in US stocks is concluding. Rather, we are noting that the fundamental, technical and psychological factors driving equity-market performance appear consistent with the latter stages of an up cycle. This particular phase can last a few years if all goes well, but the ride will likely be bumpier than in recent years. We still do not see many serious signs of overvaluation or economic imbalances in the US that would suggest imminent danger of a severe correction, much less a devastating bear market on par with the 2008-to-2009 experience.

Although equity markets underwent their first real correction in some 20 months during the first quarter, the pullback does not look like the start of a more serious decline. At SEI, we see two fundamental drivers behind the correction in equities and the return to more-volatile price action. The first is the upward shift in investors' interest-rate expectations as the global economy kicks into a higher gear. The second is concern that the Trump administration's recent actions on the trade front will lead to a broader trade war that could hurt global growth and push inflation higher sooner.

There certainly are cyclical pressures pushing yields up from their historic lows. The long bull market in equities and other risk-oriented assets has been sustained by the extraordinarily expansive monetary policies of the world's most important central banks. And the subsequent decline in yields across the maturity spectrum reached levels never seen before. In our view, this 37-year tailwind is turning into a headwind.

But the US Treasury yield curve remains upward sloping and, in our opinion, can narrow further without causing too many problems.

Impediments to trade—tariffs, quotas and non-tariff barriers—raise prices and reduce demand, leading to a dead-weight loss for society.

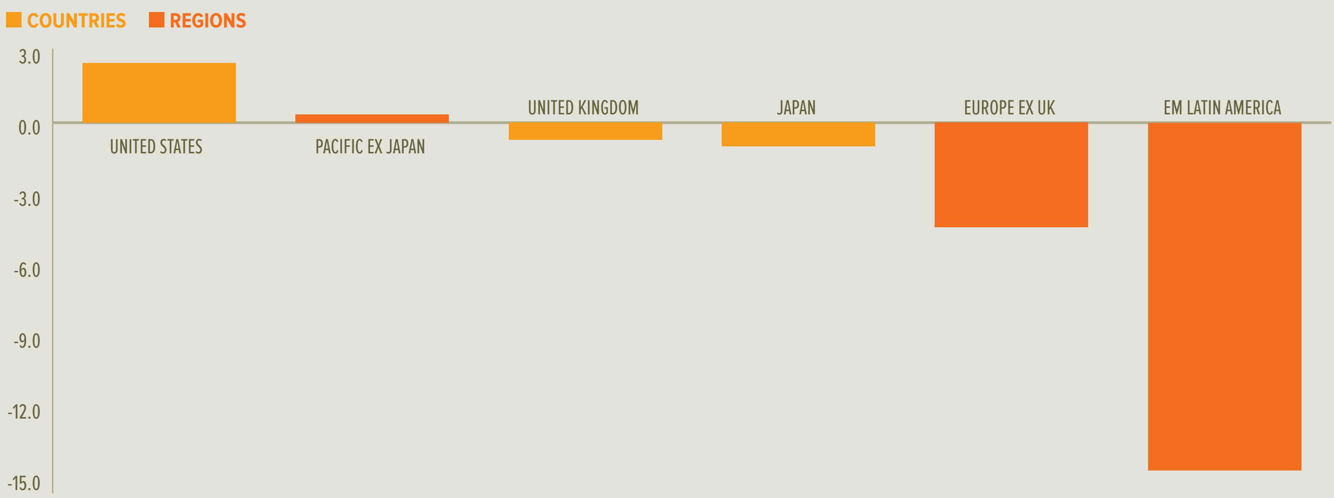
Interest-rate spreads for investment-grade, high-yield and emerging-market debt also remain near cycle lows. High-yield bonds, in particular, should be considered the canary in the coal mine. Spreads tend to widen well before the stock market tops out. Even during the recent turbulence stock-market turbulence, the option-adjusted spread on high-yield bonds held surprisingly steady.

As we have pointed out on several occasions in the past, the US equity market has historically managed to withstand the depressive impact of rising interest rates until the 10-year US Treasury reaches a level of 4% to 5%. Owing to the structural decline in bond yields and the elevated equity valuations that have resulted, we now think it prudent to assume that the stock market will begin to struggle if the 10-year Treasury rate approaches 4% (the lower end of the traditional "danger zone").

While we maintain a positive view of equities and other risk assets, we must admit that our optimism is being tested as the Trump administration uses protectionism as a bargaining tool against friend and foe alike. Impediments to trade—tariffs, quotas and non-tariff barriers—raise prices and reduce demand, leading to a dead-weight loss for society. More jobs are lost by consuming industries than are gained by the beneficiaries of protectionism. A trade war of consequence could add to the inflation pressures that have already emerged as a result of the pick-up in economic activity and the tightening employment situation.

We are in watchful-waiting mode when it comes to trade, but think it's premature to expect a catastrophe. Our preference is to see what trade sanctions are actually levied, and how target countries respond, instead of assuming the worst from the get-go. Until there is more clarity on the extent of the US protectionist measures being put into place, we think it's best to focus on the strong fundamental backdrop. Profit growth remains vibrant, inflation is still well-contained and the Fed's decision makers would prefer to normalise monetary policy in a steady, predictable fashion. For now, we believe it's proper for us to maintain a "risk-on" investment orientation.

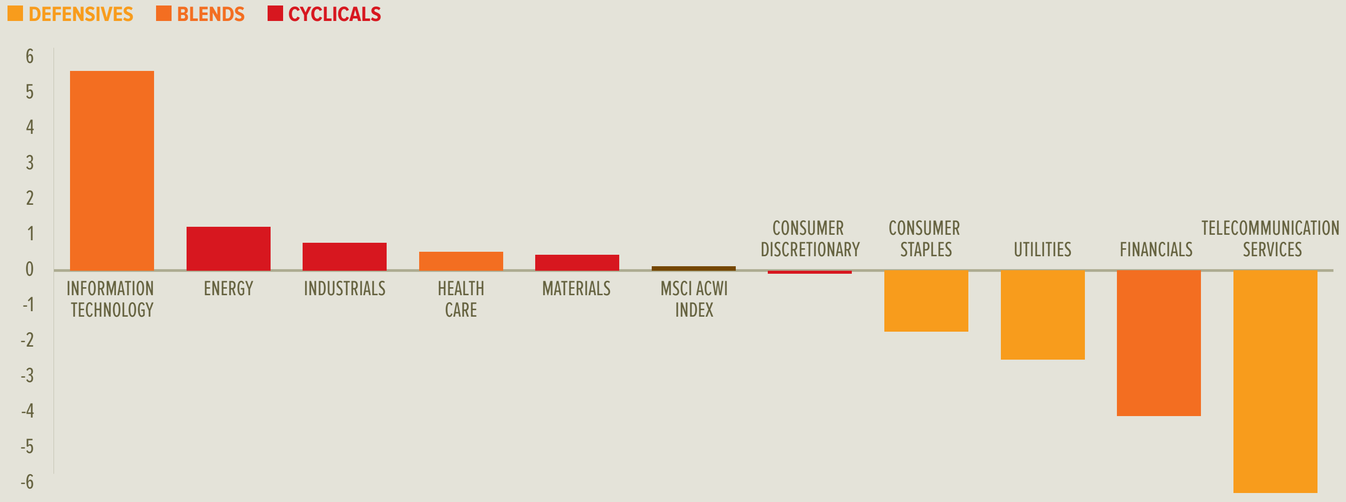
## Regional Equity Performance in May 2018 (Percent Return)




Sources: FactSet, Lipper. See "Corresponding Indexes for Regional Equity Performance Exhibit" in the Index Descriptions section for more information.

**All references to performance are in US dollar terms unless otherwise noted. See Standardised Performance for more information.**

## Global Equity Sector Performance in May 2018 (Percent Return)




Sources: FactSet, Lipper. MSCI ACWI Index Sector Components (Cyclicality determined by SEI).

We may have finally begun to see a shift away from the poor relative performance of eurozone equities that has persisted since the middle of last year. The eurozone economy has been gaining traction since early 2016; we judged the potential for future growth to be much greater in the eurozone than in the US given their respective points in the economic cycle. We also looked for a jump in earnings, as European companies have a high degree of operational leverage, while valuation considerations also provided support to our bullish rationale.

On a fundamental basis, we think investors remain sceptical about the staying power of the European expansion. The European Central Bank is moving away from the asset purchases that have supported the eurozone's economic recovery and credit markets. And by mid-year 2019, if not sooner, we should see the first steps toward normalising policy rates—although negative yields are an absurdly low starting point. While the outlook for the eurozone is mixed, it seems bright and sunny compared to that of the UK. As we have mentioned in previous reports, Brexit has become the overwhelming obsession of investors and policymakers.

US congressional elections will take place in November, potentially jeopardising current Republican control of the House of Representatives. Legislating in the US has been tough enough under a "unified" government; it will become next to impossible under split governance, should power become more evenly distributed across the two major parties. We would also expect a Democratic House to ramp up the pace of investigations into the president, his staff and his Cabinet.

The past nine years have been full of challenges and uncertainties. The years ahead don't seem to promise anything different in that regard. Yet the bull market has managed through it all. Let's give it the benefit of the doubt for a while longer. Although the ride has turned bumpier, we believe that economic fundamentals justify further gains in US and global equity prices. The synchronised global expansion is still alive and well. Earnings continue to climb briskly around the world. US companies' cash flows and earnings, meanwhile, are benefiting mightily from the tax reform passed late last year by the US government. There really are few signs that a recession will rear its ugly head anytime in the next 12 to 18 months.

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All references to performance are in US dollar terms unless otherwise noted. See Standardised Performance for more information.

## Standardised Performance

| | | 1 year to 31-May-18 | 1 year to 31-May-17 | 1 year to 31-May-16 | 1 year to 31-May-15 | 1 year to 31-May-14 |
|---|---|---|---|---|---|---|
| **Key Measures** | | | | | | |
| Dow Jones Industrial Average | | 18.91% | 21.16% | 1.39% | 10.28% | 13.27% |
| S&P 500 Index | | 14.38% | 17.47% | 1.72% | 11.81% | 20.45% |
| NASDAQ Composite Index | | 21.34% | 26.75% | -1.18% | 20.89% | 24.33% |
| MSCI ACWI Index (Net) | | 11.84% | 17.53% | -5.42% | 5.08% | 17.15% |
| Bloomberg Barclays Global Aggregate Index | | 1.72% | 0.77% | 5.32% | -6.00% | 5.35% |
| **Major Index Performance** | | | | | | |
| Bloomberg Barclays Global Aggregate ex-Treasury Index | | 1.23% | 2.29% | 2.89% | -3.38% | 5.23% |
| Bloomberg Barclays Global Aggregate Index | | 1.72% | 0.77% | 5.32% | -6.00% | 5.35% |
| Bloomberg Barclays Global Treasury Index | | 2.14% | -0.50% | 7.43% | -8.21% | 5.46% |
| MSCI ACWI ex-USA (Net) | | 9.67% | 18.24% | -11.39% | -0.90% | 14.54% |
| MSCI Emerging Markets Index (Net) | | 14.03% | 27.41% | -17.63% | -0.01% | 4.27% |
| MSCI World Index (Net) | | 11.57% | 16.42% | -3.96% | 5.70% | 18.87% |
| **Fixed-Income Performance** | | | | | | |
| US Treasury Inflation-Protected Securities (TIPS) | Bloomberg Barclays 1-10 Year U.S. TIPS Index | 0.36% | 2.17% | 1.12% | -1.13% | 0.47% |
| Global Non-Government | Bloomberg Barclays Global Aggregate ex-Treasury Index | 1.23% | 2.29% | 2.89% | -3.38% | 5.23% |
| Global Sovereigns | Bloomberg Barclays Global Treasury Index | 2.14% | -0.50% | 7.43% | -8.21% | 5.46% |
| US Investment-Grade Corporates | Bloomberg Barclays U.S. Corporate Investment Grade Index | 0.06% | 4.26% | 3.62% | 2.72% | 4.68% |
| US Asset-Backed Securities (ABS) | Bloomberg Barclays U.S. Asset-Backed Securities Index | 0.32% | 1.54% | 1.81% | 1.74% | 1.18% |
| US Mortgage-Backed Securities (MBS) | Bloomberg Barclays U.S. Mortgage-Backed Securities Index | -0.30% | 1.16% | 2.71% | 3.34% | 3.38% |
| US Treasurys | Bloomberg Barclays U.S. Treasury Index | -0.83% | 0.00% | 3.01% | 3.07% | 1.06% |
| US High Yield | ICE BofAML US High Yield Constrained Index | 2.29% | 13.84% | -0.88% | 1.86% | 7.93% |
| Emerging Markets (External) | JPMorgan EMBI Global Diversified Index | -0.56% | 9.77% | 4.55% | 2.46% | 5.77% |
| Emerging Markets (Local) | JPMorgan GBI-EM Global Diversified Index | 1.01% | 12.16% | -4.86% | -13.49% | -1.37% |
| **Regional Equity Performance** | | | | | | |
| United Kingdom | FTSE All-Share Index | 9.80% | 10.44% | -10.63% | -2.23% | 20.44% |
| EM Latin America | MSCI Emerging Markets Latin America Index (Net) | 3.67% | 27.34% | -16.25% | -21.01% | -4.75% |
| Europe ex UK | MSCI Europe ex UK Index (Net) | 3.29% | 19.28% | -8.94% | -5.11% | 25.17% |
| Pacific ex Japan | MSCI Pacific ex Japan Index (Net) | 12.75% | 17.97% | -10.98% | -3.15% | 11.74% |
| United States | S&P 500 Index | 14.38% | 17.47% | 1.72% | 11.81% | 20.45% |
| Japan | TOPIX, also known as the Tokyo Stock Price Index | 15.81% | 16.45% | -5.77% | 16.36% | 7.06% |
| **Global Equity Sector Performance** | | | | | | |
| MSCI ACWI Index | | 11.84% | 17.53% | -5.42% | 5.08% | 15.68% |
| MSCI ACWI Consumer Discretionary Index | | 14.08% | 17.69% | -4.28% | 11.64% | 16.58% |
| MSCI ACWI Consumer Staples Index | | -5.00% | 10.23% | 6.14% | 4.51% | 10.54% |
| MSCI ACWI Energy Index | | 21.26% | 6.19% | -13.29% | -19.45% | 15.38% |
| MSCI ACWI Financials Index | | 11.52% | 22.30% | -11.15% | 4.62% | 11.87% |
| MSCI ACWI Healthcare Index | | 6.90% | 7.63% | -6.64% | 21.37% | 21.68% |
| MSCI ACWI Industrials Index | | 9.89% | 20.23% | -2.69% | 1.88% | 18.74% |
| MSCI ACWI Information Technology Index | | 26.21% | 34.57% | -1.38% | 15.85% | 21.90% |
| MSCI ACWI Materials Index | | 17.52% | 23.62% | -13.47% | -5.20% | 8.61% |
| MSCI ACWI Telecommunication Services Index | | -6.83% | 3.46% | -1.14% | 1.32% | 17.60% |
| MSCI ACWI Utilities Index | | -0.62% | 11.16% | 0.96% | -0.46% | 15.65% |

**All references to performance are in US dollar terms unless otherwise noted. See Standardised Performance for more information.**

## Glossary of Financial Terms

**Bear market:** A bear market refers to a market environment In which prices are generally falling (or are expected to do so) and investor confidence is low.

**Bull market:** A bull market refers to a market environment in which prices are generally rising (or are expected to do so) and investor confidence is high.

**Fundamentals:** Fundamentals refers to data that can be used to assess a country or company's financial health such as amount of debt, level of profitability, cash flow, inventory size, etc.

**Option-adjusted yield spreads:** A calculation used to help determine price differences between similar products that allow different embedded options.

**Yield curve:** The yield curve represents differences in yields across a range of maturities of bonds of the same issuer or credit rating (likelihood of default). A steeper yield curve represents a greater difference between the yields. A flatter curve indicates the yields are closer together.

**Yield spreads:** Yield spreads represents the difference in yields offered between different types of bonds. If they tighten, this means that the difference has decreased. If they widen, this means the difference has increased.

## Corresponding Indexes for Key Measures Exhibit

| | |
|---|---|
| Dow Jones Industrial Average | The Dow Jones Industrial Average is a widely followed market indicator based on a price-weighted average of 30 blue-chip New York Stock Exchange stocks that are selected by editors of The Wall Street Journal. |
| NASDAQ Composite Index | The NASDAQ Composite Index is a market-value-weighted index of all common stocks listed on the National Association of Securities Dealers Automated Quotations (NASDAQ) system, representing a subset of the US equity market. |
| MSCI ACWI Index | The MSCI ACWI Index is a market-capitalization-weighted index composed of over 2,000 companies, and is representative of the market structure of 46 developed- and emerging-market countries in North and South America, Europe, Africa and the Pacific Rim. The Index is calculated with net dividends reinvested in US dollars. |
| Bloomberg Barclays Global Aggregate Index | The Bloomberg Barclays Global Aggregate Index is an unmanaged market-capitalization-weighted benchmark that tracks the performance of investment-grade fixed-income securities denominated in 13 currencies. The Index reflects reinvestment of all distributions and changes in market prices. |
| Chicago Board Options Exchange Volatility Index (VIX) | The Chicago Board Options Exchange Volatility Index (VIX) tracks the expected volatility in the S&P 500 Index over the next 30 days. A higher number indicates greater volatility. |

## Corresponding Indexes for Major Index Performance Exhibit

| | |
|---|---|
| MSCI ACWI ex-USA Index | The MSCI ACWI ex-USA Index includes both developed- and emerging-market countries, excluding the US. |
| MSCI Emerging Markets Index | The MSCI Emerging Markets Index is a free float-adjusted market-capitalization-weighted index designed to measure the performance of global emerging-market equities. |
| MSCI World Index | The MSCI World Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed markets. |
| Bloomberg Barclays Global Aggregate Index | The Bloomberg Barclays Global Aggregate Index is an unmanaged market-capitalization-weighted benchmark that tracks the performance of investment-grade fixed-income securities denominated in 13 currencies. The Index reflects reinvestment of all distributions and changes in market prices. |
| Bloomberg Barclays Global Aggregate ex-Treasury Index | The Bloomberg Barclays Global Aggregate ex-Treasury Index is an unmanaged market index representative of the total return performance of ex-Treasury major world bond markets. |
| Bloomberg Barclays Global Treasury Index | The Bloomberg Barclays Global Treasury Index is composed of those securities included in the Bloomberg Barclays Global Aggregate Index that are Treasury securities. |

## Corresponding Indexes for Fixed-Income Performance Exhibit

| | |
|---|---|
| US High Yield | BofA Merrill Lynch U.S. High Yield Master II Constrained Index |
| Global Sovereigns | Bloomberg Barclays Global Treasury Index |
| Global Non-Government | Bloomberg Barclays Global Aggregate ex-Treasury Index |
| Emerging Markets (Local) | JPMorgan GBI-EM Global Diversified Index |
| Emerging Markets (External) | JPMorgan EMBI Global Diversified Index |
| US Mortgage-Backed Securities (MBS) | Bloomberg Barclays U.S. Mortgage Backed Securities Index |
| US Asset-Backed Securities (ABS) | Bloomberg Barclays U.S. Asset-Backed Securities Index |
| US Treasurys | Bloomberg Barclays U.S. Treasury Index |
| US Treasury Inflation-Protected Securities (TIPS) | Bloomberg Barclays 1-10 Year U.S. TIPS Index |
| US Investment-Grade Corporates | Bloomberg Barclays U.S. Corporate Investment Grade Index |

## Corresponding Indexes for Regional Equity Performance Exhibit

| | |
|---|---|
| United States | S&P 500 Index |
| United Kingdom | FTSE All-Share Index |
| Pacific ex Japan | MSCI Pacific ex Japan Index (Net) |
| Japan | TOPIX, also known as the Tokyo Stock Price Index |
| Europe ex UK | MSCI Europe ex UK Index (Net) |
| EM Latin America | MSCI Emerging Markets Latin America Index (Net) |

**All references to performance are in US dollar terms unless otherwise noted. See Standardised Performance for more information.**

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