Strong Start to the Second Quarter

Monthly Market Commentary

April 2017

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- Stocks rallied globally and bonds generally followed suit as a wave of geopolitical developments moderated in April.
- Global fixed income was led by emerging markets, sovereign bonds and US high-yield bonds. Europe delivered the strongest country-level equity-market performance.
- We expect to continue viewing equity-market price corrections as buying opportunities until interest rates begin rising at a faster-than-anticipated pace or the US economy shows early signs of entering a recession.

Economic Backdrop

Stocks rallied globally and bonds generally followed suit as the wave of geopolitical developments that marked the first quarter of 2017 moderated in April. Oil prices dropped mid-month despite a commitment by the Organization of the Petroleum Exporting Countries to maintain supply cuts as US producers continued to ramp up production. The French presidential election narrowed, with polls favouring the establishment candidate by a sizeable margin. European Union (EU) members agreed to formal Brexit negotiating guidelines in late April, presenting a convincing united front as they sought to warn the UK that a phased approach—first separation, then establishment of trade relations—would prevail over simultaneous discussions or a contingent deal. Prime Minister Theresa May called a snap election, set for early June, in an effort to increase her Conservative Party's majority as Brexit negotiations get underway.

Neither the US Federal Open Market Committee nor the Bank of England's Monetary Policy Committee met in April. The European Central Bank (ECB) held its benchmark rates firm and followed through on assurances that it would begin reducing its monthly asset purchases (from €80 billion to €60 billion). The Bank of Japan also maintained its posture, but lowered inflation projections—suggesting its accommodative policy would persist for the foreseeable future.

British retail sales volumes sharply improved in April, according to the latest distributor survey—only partly attributable to the Easter holiday, as sales appeared elevated even on a seasonal basis. The survey provided a welcomed indicator of brightening conditions after disappointing March sales. Manufacturing activity jumped to the highest level in three years, reversing the decelerating growth of recent months. Consumer prices increased by 2.3% in the year through March, remaining unchanged from February's reading and suggesting a levelling-off from recently rising inflation pressures as oil prices recovered earlier this year. Claimant-count unemployment edged upward in March; in the December-to-February period, the broader unemployment rate remained unchanged and the average year-over-year earnings rate rose to 2.3%. The UK economy expanded by 0.3% during the first quarter and by 2.1% in the one-year period ending March; business and government services contributed, while transport and hotels lagged.

Eurozone manufacturing activity continued to briskly expand, depicting the strongest growth in six years, buoyed by new orders and output. Growth within the services sector was also strong, remaining at multi-year highs. Industrial production slipped in February (the latest data available) following a significant gain in the previous month; year-over-year data showed slow and uneven output improvement. Consumer prices increased by 1.9% in the one-year period ending April, a sharp jump the annual figure from last month, indicating accelerating inflation. Producer prices were unchanged in March, but continued to climb year over year (to 4.5%). Economic sentiment strengthened further in April, with gains at both the industry and consumer levels. Labour-market improvement stalled in March, as the unemployment rate held at 9.5%; the rate among youth edged down to 19.4%.

Growth in US manufacturing industries appeared to moderate during April, albeit at still-healthy levels. Consumer confidence slid slightly in the same month, as sentiment about current conditions fell, but remained strong overall. Jobless claims hovered near historically low levels in April, with the four-week moving average for continuing claims falling mid-month to a 17-year low. Job creation in the US slowed by more than expected in March, partly due to bad weather conditions in the Northeast. The unemployment rate nevertheless fell by 0.2% to 4.5%, the lowest level since May 2007. Average hourly earnings rose by 2.7% year over year. Personal incomes climbed by 0.2% in March (on the low side of recent trends) and consumer spending rates were unchanged for the second straight month. The core consumer price inflation rate declined to 1.6%, below the US Federal Reserve's (Fed) inflation target. First-quarter gross domestic product expanded by a weaker-than-expected 0.7% amid the slowest rate of consumer spending in almost eight years and waning inventory growth. Residential and non-residential investments were both strong.

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Market Impact[1]

Global fixed-income markets climbed in April, according to the Bloomberg Barclays Global Aggregate Index, once again driven by emerging markets; foreign-currency-denominated (external) debt bested local-currency-denominated debt (which had been the best-performing segment during the first quarter). Global sovereign securities performed almost as well as local-currency-denominated emerging-market debt, followed closely by US high-yield bonds. Global non-government debt and US investment-grade corporate fixed income also delivered strong performances. US Treasurys and mortgage-backed securities performed well, albeit with substantially lower returns than the aforementioned segments, trailed by US Treasury inflation-protected securities and asset-backed securities, which were both modestly positive.

The global equity-market advance continued apace in April, as reflected by the MSCI ACWI Index (Net). Europe led, with the best returns delivered by non-eurozone countries (Poland and Turkey), followed by Greece, Austria, Denmark and Finland. The poorest performers were less geographically concentrated; Peru delivered the deepest loss, followed by Canada, Egypt, Qatar and Colombia. The global consumer discretionary sector led, followed closely by information technology and industrials. Healthcare and consumer staples were also strong, while financials, materials and utilities trailed the overall MSCI ACWI Index (Net) but were still positive. Energy was the weakest sector, while telecommunications was also negative.

Index Data (April 2017)

- The MSCI ACWI Index (Net), used to gauge global equity performance, advanced by 1.56%.
- 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 12.37 to 10.82.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, fell to $50.60 a barrel on the last day in March to $49.33 at the end of April.
- The US dollar weakened relative to sterling and the euro, but modestly strengthened versus the Japanese yen, ending April at $1.29 against sterling, $1.09 versus the euro and at 111.47 yen.

SEI’s View

There’s no denying that the “Trump reflation” trade in the US 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 tax-reform debate. We expect the US economy will continue to expand; although a step-up in growth will likely hinge on how successfully the Trump administration pushes through pro-cyclical legislation and rule changes.

We are witnessing the strongest synchronized advance in European economic data across developed and emerging economies since the 2009-to-2010 period. 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 initially tapering its bond-buying programme, as it does not want to repeat the mistake it made in 2011 of prematurely hiking 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; even a modest programme toward a more business-friendly environment and flexible labour market would represent a step in the right direction. Perhaps most importantly, the threat of an upset victory by Marine LePen of the populist National Front appears to have been reduced.

Investors remain nervous about Europe’s periphery; Italian bond yields, for example, remain close to a two-year high in absolute terms and at a three-year high relative to German bunds (yields move inversely to prices). Although progress in Italy has been made in terms of recapitalising its banking system and writing off bad debt, it will likely require a multi-year process before the country is on sounder footing.

[1] In USD, Global Bonds = Bloomberg Barclays Global Aggregate Bond Index, US High Yield = BofA Merrill Lynch US 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, US Mortgage-Backed Securities = Bloomberg Barclays US Mortgage Backed Securities Index, US Asset-Backed Securities = Bloomberg Barclays US Asset-Backed Security Index, US TIPS = Bloomberg Barclays 1-10 Year US TIPS Index, US Investment-Grade Corporate = Bloomberg Barclays Investment Grade US Corporate.

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UK Prime Minister May 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 since the referendum last summer. Although inflation pressures seem to be building, the Bank of England does not appear in a rush to tighten policy; uncertainties regarding Brexit are too great.

Hopes for a soft Brexit have faded in recent months, as Prime Minister May's government began seeking severe limits on the free movement of people from the EU and taking back sovereignty from the European Court of Justice. The EU, meanwhile, said it wants to impose an exit fee of up to €60 billion—based on an estimate of net liabilities owed by the UK—before substantive discussions had even begun. It has been a bad start to a challenging process.

Emerging equity and bond markets swooned immediately after the US presidential election last November in response to the incoming administration's aggressive trade stance—but have since begun to climb a big, beautiful wall of worry. The MSCI Emerging Markets Index (Total Return) is in new cycle-high territory in both local-currency and US dollar terms. In similar fashion, emerging-market bond yields declined in April, with option-adjusted spreads reaching multi-year lows versus US Treasurys.

Investors seemed to be taking a more relaxed view of the future, assuming that the new administration's bark is much worse than its bite. That being said, it's important to keep in mind that US President Donald Trump has the final say—and he seems intent on delivering his promise to reduce import competition and return manufacturing capacity to the US

During the last synchronized global expansion following the 2007-to-2009 recession, China led the way to higher economic ground with a debt-infused boom, while the US 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 has the role of best-supporting actor on the world stage.

The Chinese economy is responding favourably to the fiscal and monetary stimulus set in motion by the government in 2015, 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 growth rebound within more-reliable measures of economic activity.

Imports have risen in the past year, as China continues the process of shifting its economic model from focusing on export/industrial to focusing on consumer/services. Exports to the US have increased, however, even as they decline modestly to other regions of the world. China remains, by far, the single-biggest contributor to the US merchandise trade deficit. We are still concerned that the Trump administration could decide to levy punitive tariffs against China. 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 economic or political waves 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. As such, we expect China to continue its steady-to-better growth.

In our opinion, the valuation of US equities is a moderate concern at this point. Granted, economic, earnings and political disappointments are not as easily ignored now as they might otherwise be at lower valuation levels. We nevertheless expect to continue viewing price corrections as buying opportunities until interest rates begin rising at a faster-than-anticipated pace or the US economy shows early signs of entering a recession. 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 outperform.

In fixed-income markets, we anticipate the normalisation of interest rates to higher levels to proceed at a sedate pace. We don't believe that inflation is the global economy's biggest problem. We believe it's a lack of growth. That seems to be changing, but we do not expect aggressive tightening by central banks. The Fed may be leading the way, but even it is likely to tread carefully until inflation becomes a bigger problem. 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.

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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 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.
- Option-adjust yield spread: Option-adjusted yield spreads are a calculation used to help determine price differences between similar products that allow different embedded options.
- Treasury inflation-protected securities: Treasury Inflation-Protected Securities are US 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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