Markets Paid Little Mind to Politics

Monthly Market Commentary

May 2017

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- Capital markets demonstrated only a fleeting interest in the raft of political surprises that unfolded during May.
- Globally, fixed-income markets nearly unanimously advanced and equity markets were overwhelmingly positive; geographically diversified equity portfolios that have struggled to match the S&P 500 Index may start to outperform.
- We will continue to view equity-market corrections as buying opportunities until rates begin to quickly rise (rates move inversely to prices) or signs of recession emerge.

Economic Backdrop

Capital markets demonstrated only a fleeting interest in the raft of political surprises that unfolded during May. UK election polling showed incumbent Conservatives steadily losing their edge to the Labour Party while UK stocks rallied fairly consistently through the month. Emmanuel Macron's early-May victory in the French presidential election amounted to a significant win for the establishment; European stocks rallied to start the month, gave back gains by mid-May and finished flat. US stocks also finished where they started; volatility there was practically non-existent, outside of a mid-month spike on the appointment of a high-profile special prosecutor to investigate the possibility of collusion between Donald Trump's presidential campaign and Russia.

Brazil was the exception to the theme of politically indifferent markets: an ongoing top-level corruption scandal was blown wide open in mid-May as potential evidence emerged of a taped conversation featuring President Michel Temer approving a large hush-money bribe. Brazilian markets plummeted on the news and recovered only a portion of their losses by the end of the month. Globally, bonds generally advanced in the period. Oil prices started the month at their lowest levels since November before rallying through late-May, when the Organization of the Petroleum Exporting Countries meeting took place, and then partially retreated.

The Bank of England's (BoE) Monetary Policy Committee held firm at its mid-month meeting. While the European Central Bank (ECB) had no policy meeting scheduled for May, minutes from its late-April meeting depicted improving, albeit cautious, optimism. The US Federal Open Market Committee (FOMC) passed on the opportunity to enact changes in early May, but set up the possibility of an interest-rate hike in June (CME Group's Fedwatch futures market, which reflects investor expectations for FOMC rate-setting policy, has priced a roughly 95% probability). FOMC meeting minutes showed a detailed discussion about partially reducing Treasury and mortgage-bond assets on the US Federal Reserve's balance sheet in a gradual, predictable way. The Bank of Japan had no monetary policy meeting in May.

UK industrial trends strengthened in May on new-business growth and increased output. Manufacturing surveys showed that the strong expansion of recent months remained intact, albeit below the multi-year peak attained in April. Retail sales jumped in April after contracting in March, although trend surveys for May suggest the recovery may be short lived. Consumer prices also jumped in April, pushing year-over-year price growth to 2.7%, the highest rate in almost four years. Producer-price growth was modest on the input side during April but remained steep year over year, which may push consumer prices upward in the coming months. Claimant count unemployment increased in April, while the first-quarter unemployment rate edged down to 4.6% alongside a gain in average year-over-year earnings growth.

Eurozone manufacturing activity hit the highest level in six years and services-sector growth remained strong in May, combining to deliver the second-largest employment boost of the past decade. Economic sentiment settled in May to just below its post-financial crisis high-water mark, as a continued gain for industrial sentiment was offset by a slightly larger deterioration in consumer sentiment. An early estimate of consumer-price changes for May showed a significant slowdown in year-over-year price growth, which carried over to core-price trends (which exclude volatile food and energy components). The unemployment rate declined to 9.3% in April, and the March reading was favourably revised.

US consumer confidence slightly retreated in May but remained near the 16-year high attained in March. Manufacturing growth held firm, with new orders and exports serving as key sources of strength. Services-sector activity improved on order strength; while input costs have risen, service providers have succeeded in pushing them through on the output side. The unemployment rate declined to 4.3% in May; however, job creation was softer than expected and recent-month gains were revised down. Personal incomes increased by 0.4% in April, apace with consumer spending. Core personal consumption expenditures (the US Federal Reserve's preferred inflation gauge) settled to 1.5% year-over-year growth.

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Market Impact[1]

Global fixed-income markets advanced again in near-unanimous fashion during May. Local-currency-denominated emerging-market debt led, followed by global sovereign securities and global non-government debt. US investment-grade corporate fixed income also performed strongly, followed by US high-yield and foreign-currency-denominated (external) emerging-market debt. US Treasurys and mortgage-backed securities performed well and US asset-backed securities were positive, while US Treasury inflation-protected securities were modestly negative.

Global equity markets, as reflected by the MSCI ACWI Index (Net), were overwhelmingly positive in May, primarily within defensives. The utilities sector performed best, followed closely by information technology and then consumer staples. Telecommunications delivered strong performance, while healthcare, consumer discretionary and industrials also performed well. Materials and financials were slightly positive, while energy was the only negative sector. Europe was well-represented among the top-performing countries: Greece, Hungary, Austria and Portugal outperformed, followed by Korea, Finland, Egypt and Peru. Russia suffered the steepest decline, followed by Brazil, Australia and Qatar. Israel and Canada were also slightly negative.

Index Data (May 2017)

- The MSCI ACWI Index (Net), used to gauge global equity performance, advanced by 0.71%.
- The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, increased by 1.55%.
- 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 10.82 to 10.41.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, fell from $49.33 a barrel at the end of April to $48.32 on the last day in May.
- The US dollar modestly strengthened relative to sterling, but weakened versus the euro and Japanese yen, ending May at $1.29 against sterling, $1.12 versus the euro and at 110.59 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 an increase 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, the economic reform proposals of newly elected President Emmanuel Macron seem reasonable; even a modest programme toward a more business-friendly environment and flexible labour market would represent a step in the right direction.

Investors remain nervous about Europe's periphery; Italian bond yields, for example, remain close to a two-year high in absolute terms and near 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.

UK Prime Minister Theresa May started the clock on the UK's exit from the European Union (EU). Like other observers, we have been surprised at how well the economy has performed since the referendum last summer. The BoE does not appear in a rush to tighten policy despite inflation pressures seeming to build; 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,

[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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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 May, 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 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 rising interest rates 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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