Quarterly Market Commentary:
The Tide Continued to Rise in the Second Quarter
Second Quarter 2017

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- Political developments abounded in the UK, continental Europe and the US, as markets continued to signal optimistic expectations.
- Global fixed-income markets had another strong showing, and global equity markets continued to rally (albeit to a lesser degree than during the previous quarter). Emerging markets outpaced developed markets.
- Emerging stock markets still look attractive on a valuation basis relative to developed markets. Investors were also drawn to the region on improving global economic fundamentals.

Economic Backdrop

Political developments abounded during the second quarter: UK Conservatives lost their parliamentary majority after calling an election; Emmanuel Macron was elected to the French presidency and secured a congressional majority for his centrist En Marche! Party; US President Donald Trump scolded NATO and sidestepped a mutual-defence endorsement, and faced the appointment of a special prosecutor to investigate whether his campaign colluded with Russia during last year's election; and ISIS was weakened in Syria as well as in Iraq, which regained control of Mosul in a near-total victory.

Stocks climbed globally, but the results were uneven. US stocks advanced after strong first-quarter earnings reports. Equity markets were roughly flat in Europe and the UK after early-quarter weakness, followed by a rally, before sliding into quarter end. Japanese stocks had an impressive quarter, as did Chinese equity markets. Brazil suffered a major setback midway through the quarter when President Michel Temer was implicated in a sweeping corruption scandal; this squandered an equity rally, which failed to recover and ended down for the period. The US Treasury yield curve flattened at an accelerating pace, with short-term interest rates increasing and intermediate- and long-term interest rates declining (yields move inversely to prices) Oil prices tumbled from an early-April high of $53.40 per barrel of West Texas Intermediate crude to a late-June low of $42.53 per barrel, before bouncing slightly higher by quarter end.

The US dollar continued a slide that began in the New Year; its value has declined in the first half of 2017 by more than 5% versus a broad trade-weighted basket of foreign currencies. The euro appreciated by 7.3% against the greenback in the second quarter alone. US dollar weakness is particularly notable in the context of the US Federal Reserve's (Fed) monetary-policy tightening endeavours, which would normally be expected to support US dollar strength. The Fed attracted renewed attention this quarter—not just for its second benchmark rate hike of 2017, but also for looking beyond rates and focusing on quantitative tightening via balance-sheet reduction.

The Bank of England's Monetary Policy Committee made no changes during the quarter; but more hawkish votes were cast for a rate hike, as the latest quarterly data showed the rate of inflation above the central bank's 2% target. The European Central Bank (ECB) also held firm, continuing asset purchases as anticipated—yet betrayed optimism by changing statement language to suggest that members don't expect benchmark rates to move lower, in an acknowledgement of firming economic conditions. The Bank of Japan (BOJ) maintained its "Quantitative and Qualitative Easing (QQE) with Yield Curve Control" programme.

The UK services sector started the quarter with a jump, slowed through May and June, and ended below its March level. Manufacturing followed a similar arc, but finished the second quarter roughly flat. Construction activity peaked in May, yet still improved overall for the period. Labour-market conditions softened, with an uptick in claimant-count unemployment and a downtick in average year-over-year earnings growth.

Eurozone manufacturing activity crept higher for the tenth straight month through June, hitting its highest growth level in more than six years. Services growth moderated during the quarter, but held at robust levels amid increasing new orders and backlogs. The unemployment rate continued to edge lower, holding at 9.3% in May.

US manufacturers across the board expanded only modestly through May, at which point some began to see a sharp jump in activity while others maintained a moderate pace of growth. The services sector ended the quarter where it began, according to preliminary June data depicting middling growth. The unemployment rate fell through April and May, to 4.3%, although year-over-year average hourly earnings growth moderated in the first two months of the quarter.

Market Impact[1]

Global fixed-income markets had another strong quarter, as measured by the Bloomberg Barclays Global Aggregate Index. Local-currency-denominated emerging-market debt retained its lead—thanks in part to US dollar weakness, followed by global non-government debt and US investment-grade corporate fixed income. Global sovereign securities, foreign-currency-denominated (external) emerging-market debt, and US high-yield bonds came next, all performing closely in line with one another. US Treasurys also performed well, as did US mortgage- and asset-backed securities. US Treasury inflation-protected securities had the only negative performance, as inflation expectations moderated amid the Fed's firming stance on monetary policy.

Global equity markets continued to rally in the second quarter, as measured by the MSCI ACWI Index (Net), albeit to a lesser degree than during the first quarter. Emerging markets outperformed the developed world by a significant margin, and eight of the top-10 performing countries were within non-core Europe. Greece had the best quarter, followed by Austria, Hungary and Turkey. Qatar had the poorest performance, as it was effectively cut off from neighbours via sanctions late in the quarter, followed by Russia and Brazil. Chile and Australia had the only other losses during the second quarter, which were mild relative to the bottom three. Healthcare was the top-performing global sector, followed by information technology, industrials and financials. There were only two negative-performing sectors: energy, which significantly lagged all others, as well telecommunications.

Index Data (Second Quarter 2017)

- The MSCI ACWI Index (Net), used to gauge global equity performance, rose by 4.27%.
- The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, advanced by 2.60%.
- 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 12.37 to 11.18.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, moved from $50.60 per barrel on the last day in March to $46.04 at the end of June.
- The US dollar weakened against sterling and the euro, but modestly strengthened versus the Japanese yen, ending June at $1.30 against sterling, $1.14 versus the euro and at 112.36 yen.

SEI's View

At the start of this year, SEI held an optimistic view regarding the path of the US economy, corporate profits and, by extension, the stock market. We saw a great opportunity for the passage of business-friendly tax and regulatory reforms; but our hopes on legislative policy now appear too optimistic. Trump's unpopularity has emboldened the opposition to put up a unified resistance.

US stock-market sectors that did well immediately following the election have corrected sharply or lagged the overall market meaningfully in the year to date. By contrast, post-election laggards have bounced back sharply. Throughout these gyrations, the US equity market has managed to climb to new record highs. The lack of volatility has brought the widely-watched Chicago Board Options Exchange Market Volatility Index to extremely low levels, which we would argue increases the odds of at least a garden-variety correction.

Although our optimism is being tested, we are gamely sticking to our expectation that a major tax bill will be pushed through Congress. Original hopes of a big cut in US corporate tax rates will most likely be replaced by a smaller cut. This fiscal stimulus should still boost economic growth prospects, but could eventually add to inflationary pressures since the country's economy is edging closer to full employment.

Fed Chair Janet Yellen and a majority of her colleagues might be coming to the same conclusion, as evidenced by the second federal funds rate hike this year and apparent intentions to reduce the size of Fed's balance sheet. The pace of quantitative tightening should not be exceptionally disruptive to the bond market, at least during its ramp-up phase. But the Fed's selling could aggravate upward pressure on bond yields if investors become more concerned about the inflation

[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.

outlook. With the 10-year Treasury bond currently yielding just 2.25%, however, it is obvious that inflation concerns are not yet paramount.

One of the great puzzles is the lack of upward pressure on the US inflation rate despite a tightening labour market. Wages and salaries continued to rise at a sedate pace, so corporate profit margins remained unusually robust despite the aging economic expansion. The connection between tight labour markets and wage inflation has seemingly been severed by slow economic growth; little visible progress on tax reform and fiscal policy stimulus; weak oil pricing; and the secular disinflationary forces of demographics and disruptive technological change.

We believe this is why investors have returned to strategies emphasizing yield and stability. Unfortunately, it's hard to see the value in fixed-income yields that are so low in absolute terms and credit spreads that are tight relative to Treasury bonds. We do not think this lack of appeal portends imminent danger since inflation also is still low—but it does increase the vulnerability of fixed-income assets to a negative surprise (as is the case with the VIX and US equities).

The European equity bounce has been strong thus far in 2017, with the MSCI European Economic and Monetary Union Index (Total Return) gaining 20% in US dollar terms—reflecting the strength of the euro against the greenback. Economic sentiment in the region has risen to the highest level since 2007, suggesting that economic growth may soon accelerate. Perhaps more important for investors, eurozone earnings were beginning to pick up in a recovery that appears to have momentum.

The ECB's expansion efforts seem to have finally had a positive impact. Loan growth accelerated to its best pace in six years—an encouraging-yet-slow expansion that argues strongly in favour of ECB President Mario Draghi's long-standing preference to maintain the current pace of quantitative easing at least through 2017.

The recent UK election result means the country is now far more likely to move toward a "soft" Brexit. In our view, U.K services industries and the City of London have more to gain from a hybrid relationship with the European Union than from a complete sundering of the relationship (as is the wish of more hardline Brexiteers).

This latest political surprise comes at a time when the UK economy was showing mixed economic results. Inflation has been accelerating over the past year, which can be traced to sterling's 20% decline since August 2015. This has not been matched by rising incomes—UK households are falling behind, even though the unemployment rate has dropped to its lowest level in 40 years.

If a trophy were given out for the most under-rated stock market, we would give our vote to Japan. It is no secret that its economy faces serious demographic issues. Yet Japanese equity prices have outperformed both the US and Europe since 2012, when Prime Minister Shinzo Abe entered office. Governance of large, publicly traded companies in Japan has improved quite a bit. The government has been working hard to open markets that have been protected from competition. Another factor behind the strong performance of Japanese equities stems from the liquidity infusion into the economy provided by the BOJ through its QQE programme. As a percentage of gross domestic product, the BOJ's securities holdings are almost as large as the economy itself.

As rates in the US move up and the differential versus Japanese yields widens, we look for a resumption of the weakening trend in the yen against the US dollar. This should serve as a tailwind for additional price appreciation in Japanese equities.

Developing-market equities have been on a tear this year, with the MSCI Emerging Markets Index climbing almost 19% in US dollar terms in the year to date, and a still-substantial 15% when measured in local-currency terms. To be sure, we have seen previous episodes of US equities lagging during this long bull market—but those were typically brief stumbles, lasting a mere few months. Perhaps the current bout of underperformance will prove transitory too. But we no longer view US equities as the best game in town.

Despite the gains, emerging stock markets have remained attractive on a valuation basis relative to developed markets. Investors have also been drawn to the region due to improving global economic fundamentals, with China leading the way and Brazil recording a sharp recovery from recession.

We still have concerns about the sharp increase in debt across developing economies—mostly within the corporate sector, especially in China. But at this point, we expect current trends to hold—moderate global economic growth, rising inflation that leads to commodity-price gains, and a stable or slightly weaker U.S. dollar—all of which provide a favourable macroeconomic backdrop for emerging-market economies and financial markets.

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.
- 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.
- Credit spread: Credit spread is the additional yield, usually expressed in basis points (one basis point is 0.01%), that an index or security offers relative to a comparable duration index or security (the latter is often a risk-free credit, such as sovereign government debt).
- 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.
- Hawk: Hawk refers to a policy advisor, for example at the Bank of England, who has a negative view of inflation and its economic impact and thus tends to favour higher interest rates.
- 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.
- Qualitative: Qualitative refers to security analysis based on analyst research and subjective views.
- Quantitative easing/tightening: Quantitative easing refers to expansionary efforts by central banks to help increase the supply of money in the economy; quantitative tightening refers to efforts by central banks to help decrease the supply of money in the economy.
- 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.
- 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.

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