Markets Rally into Second Half of 2017

Monthly Market Commentary

July 2017

SEI New ways. New answers.®

- Capital markets remained resilient amid geopolitical disquiet, as global stock-market volatility fell to historic lows.
- Global equity and fixed-income markets continued to climb. Local-currency-denominated emerging-market debt widened its year-to-date bond-market lead as the US dollar weakened further.
- We expect sustained moderate global economic growth, rising inflation that leads to commodity-price gains, and a stable or slightly weaker US dollar, which would provide a favourable backdrop for emerging markets.

Economic Backdrop

The second half of 2017 began with a firming of Brexit negotiating stances, with the UK committed to ending free movement of European Union citizens within its borders once the divorce has been finalised—setting up an impasse that could delay progress toward addressing ongoing trade relations. The financial settlement figure remained a sticking point, while the Irish border also became a focus. In the US, Republicans in Congress failed to agree on terms to reform its healthcare system, rendering the drive all-but-dead for the foreseeable future as the party turned its focus to tax reform. Top-level White House staff turnover generated many headlines as July progressed, with President Donald Trump installing a new chief of staff at the end of the month. US sanctions against several belligerent states received a bevy of responses: the expulsion of hundreds of diplomats in Russia, increasingly aggressive test-missile launches by North Korea, and a vow by Iran to press ahead with its ballistic missile defence program. Venezuelan President Nicolas Maduro was a personal recipient of sanctions and was labelled a dictator by the top US national security official following a contested constitutional vote and the arrest of opposition leaders.

Capital markets remained resilient in the face of geopolitical disquiet. US equities rallied, as did British, Chinese and Japanese stocks, while Europe was down a bit; stock-market volatility fell to historic lows around the globe. The US dollar continued a practically uninterrupted slide that began in the New Year, finishing the month near the bottom end of its range since early 2015 against a trade-weighted basket of foreign currencies; the euro strengthened against both the US dollar and sterling. The US Treasury yield curve continued to flatten as short-term rates rose, while long-term rates were mixed (rates move inversely to prices). West Texas Intermediate crude-oil prices rallied late in the month, closing at just over $50 per barrel as US inventories plummeted and major exporting countries vowed more production cuts.

The Bank of England's Monetary Policy Committee enjoyed a summer vacation in July. The European Central Bank (ECB) announced no changes following its mid-July meeting, and President Mario Draghi refrained from providing insight on future asset-purchase tapering decisions. The US Federal Open Market Committee (FOMC) made no changes in late July, indicating that it would begin reducing its balance sheet relatively soon. The Bank of Japan (BOJ) changed its outlook—but not its policy—during the month, increasing economic growth projections for the next few years and pushing back the expected date of reaching its target inflation level. The People's Bank of China issued its annual Financial Stability Report in early July, asserting that the asset management industry would require more supervision given its rapid expansion.

British manufacturing accelerated more than anticipated in July, reversing a recent trend toward softer growth. The claimant count jobless rate held at 2.3% in June, while broader unemployment fell to 4.5% for the March-to-May period. Average year-over-year earnings growth slowed to 1.8% during the three months ending in May. The economy grew at a 0.3% pace during the second quarter, as expected, a modest improvement from the prior quarter.

Eurozone manufacturing growth eased in July to still-healthy levels after a nine-month acceleration trend, while the services sector continued to expand. The labour market sustained its recovery in June, with the unemployment rate shrinking to a nine-year low of 9.1% from 9.3% in May. Economic growth increased to 0.6% in the second quarter, the best showing in more than two years and seventeenth straight quarter of growth.

US manufacturing surveys revealed healthy conditions in July, while services growth picked up somewhat. Personal incomes were unchanged in June, falling short of growth expectations. Core personal consumption expenditures (the FOMC's preferred inflation measure) were 1.5% higher year over year, below the FOMC's target 2% inflation level. Second-quarter economic growth accelerated to a seasonally-adjusted annualised rate of 2.6%, more than double that of the previous quarter.

All references to performance are in US dollar terms unless otherwise noted.

Market Impact[1]

Global fixed-income markets continued to climb in July, as reflected by the Bloomberg Barclays Global Aggregate Index. Local-currency-denominated emerging-market debt was the best-performing segment again, widening its year-to-date lead as the US dollar continued to weaken. Global sovereign securities and global non-government debt followed, performing well due in part to a similar currency tailwind. US high-yield bonds also delivered strong performance, trailed by foreign-currency-denominated (external) emerging-market debt and US investment-grade corporate fixed income. US Treasury inflation-protected securities, mortgage- and asset-backed securities, and Treasurys were all positive, with comparably modest returns.

Global equity markets, as reflected by the MSCI ACWI Index (Net), had strong performance in July. Latin America delivered the best regional performance, as Brazil recovered from a mid-May selloff triggered by fresh presidential corruption allegations; Brazil provided July's second-best country-level performance after Norway (both benefitted from the recent oil-price recovery given the outsized influence of the energy sector on their markets). Israel came in last, with the only negative country-level performance during the month. Materials had the best sector performance among global equities, followed by information technology and telecommunications. Energy rebounded with conviction, modestly outperforming financials, while utilities and consumer discretionary trailed at a distance despite still-strong monthly returns. Industrials and consumer staples delivered less-impressive gains. Healthcare was just slightly positive.

Index Data (July 2017)

- The MSCI ACWI Index (Net), used to gauge global equity performance, advanced 2.79%.
- The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, increased by 1.68%.
- 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 11.18 to 10.26.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, increased from $46.04 a barrel at the end of June to $50.17 on the last day of July.
- The US dollar weakened relative to sterling, the euro and Japanese yen, ending July at $1.32 against sterling, $1.18 versus the euro and at 110.5 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 performed 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 (VIX) 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 US Congress. Widespread hopes of a big cut in US corporate tax rates will most likely moderate toward aspirations for a smaller cut. Whatever the size, 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.

US Federal Reserve (Fed) Chair Janet Yellen and a majority of her colleagues may be coming to the same conclusion, as evidenced by the second federal funds rate hike this year and the apparent intentions of the FOMC to reduce the size of the central bank'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 outlook. With the 10-year US Treasury bond yielding just 2.30% at the end of July, however, it is obvious that inflation concerns are not yet paramount.

[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.

One of the great puzzles remains 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 emphasising 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, 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 have begun 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 Draghi's long-standing preference to maintain the current pace of quantitative easing at least through the end of 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 came at a time when the UK was showing mixed economic results. Inflation has been accelerating over the past year, which can be traced to sterling's steep decline since August 2015. This has not been matched by rising incomes—UK households have been falling behind, even though the unemployment rate dropped to its lowest level in 40 years.

If a trophy were given to the most underrated stock market, we would vote for 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, as the government under Abe has been working hard to open markets that were protected from competition.

Another factor behind the strong performance of Japanese equities stems from the liquidity infused into the economy by the BOJ through its quantitative and qualitative monetary-easing programme. As a percentage of gross domestic product, the central bank's securities holdings are almost as large as the economy itself.

As interest rates in the US move up and the differential versus Japanese yields widens, we anticipate the yen to resume its trend of weakening 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 far outpacing US equities in the year to date. 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 also prove transitory. 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 sizable 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.

All references to performance are in US dollar terms unless otherwise noted.

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 perceived as 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.
- 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.
- 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 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.
- 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.

Important Information:

Past performance is not an indicator of future performance.

Investments in SEI Funds are generally medium- to long-term investments. The value of an investment and any income from it can go down as well as up. Investors may get back less than the original amount invested. Additionally, this investment may not be suitable for everyone. If you should have any doubt whether it is suitable for you, you should obtain expert advice.

No offer of any security is made hereby. Recipients of this information who intend to apply for shares in any SEI Fund are reminded that any such application may be made solely on the basis of the information contained in the Prospectus. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any stock in particular, nor should it be construed as a recommendation to purchase or sell a security, including futures contracts.

In addition to the normal risks associated with equity investing, 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. Bonds and bond funds are subject to interest rate risk and will decline in value as interest rates rise. 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. Narrowly focused investments and smaller companies typically exhibit higher volatility. SEI Funds may use derivative instruments such as futures, forwards, options, swaps, contracts for differences, credit derivatives, caps, floors and currency forward contracts. These instruments may be used for hedging purposes and/or investment purposes.

While considerable care has been taken to ensure the information contained within this document is accurate and up-to-date, no warranty is given as to the accuracy or completeness of any information and no liability is accepted for any errors or omissions in such information or any action taken on the basis of this information.

This information is issued by SEI Investments (Europe) Limited, 1st Floor, Alphabeta, 14-18 Finsbury Square, London EC2A 1BR which is authorised and regulated by the Financial Conduct Authority. Please refer to our latest Full Prospectus (which includes information in relation to the use of derivatives and the risks associated with the use of derivative instruments), Key Investor Information Documents and latest Annual or Semi-Annual Reports for more information on our funds. This information can be obtained by contacting your Financial Adviser or using the contact details shown above.

All references to performance are in US dollar terms unless otherwise noted.