Economic Outlook

Second Quarter 2017

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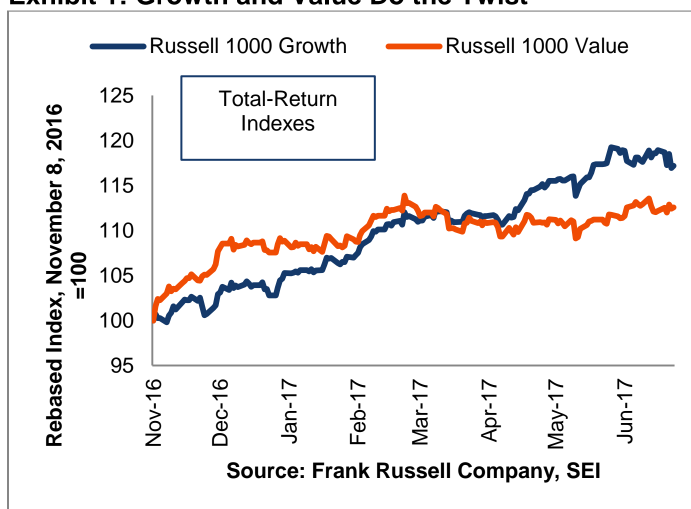
Dancing to a Song with a Bad Beat

By: James R. Solloway, CFA, Senior Portfolio Manager

Nowadays, investors are trying to dance to the tune of the markets. Unfortunately, it's a song with an almost impossible beat. In the US, for example, stock-market sectors that performed well immediately following the presidential election last November have either sharply corrected (energy, telecommunications) or have meaningfully lagged the overall market in the year to date (financials). By contrast, post-election laggards (utilities, consumer staples, real estate, healthcare and, until recently, technology) have bounced sharply back.

This shifting of fortunes since President Donald Trump's victory is also reflected in value and growth performance, as measured by the Russell 1000 Growth Index versus the Russell 1000 Value Index on a total-return basis (Exhibit 1). Value stocks had a terrific run into mid-December, climbing about 9%. This momentum dissipated between mid-December and February, allowing growth stocks to narrow the performance gap. Both value and growth then spiked higher for a few weeks, before each peaked around the beginning of March. Since then, value stocks have generally not trended in either direction, while growth has enjoyed a strong run to the upside on the back of the big technology companies. In the closing weeks of the second quarter, market dynamics appeared to be changing yet again. Now it's the big technology leaders that are suddenly losing altitude.

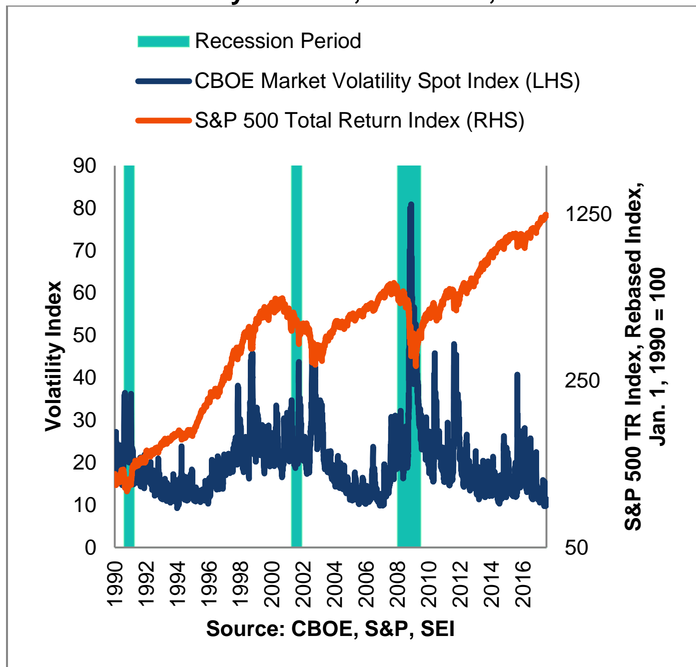
Exhibit 1: Growth and Value Do the Twist



Source: Frank Russell Company, SEI

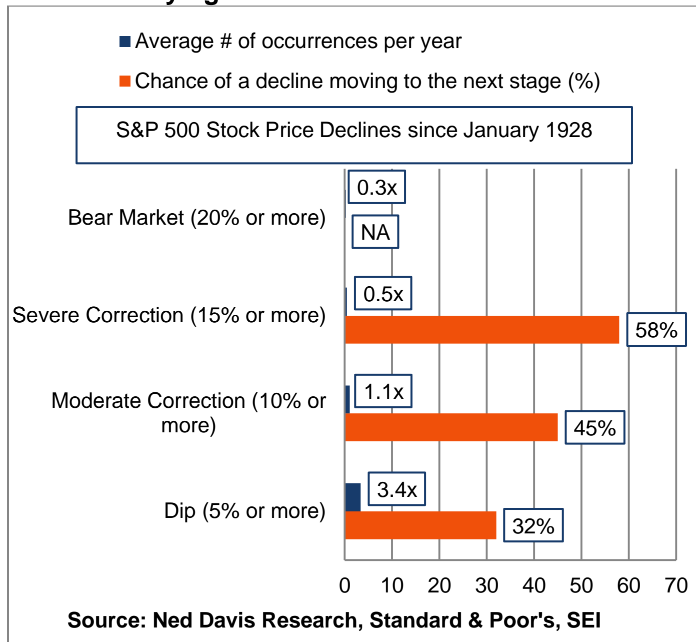
Throughout these gyrations, the US equity market has managed to climb to new record highs (as measured by the S&P 500 Index). In fact, the lack of volatility in the overall stock market has brought the widely watched Chicago Board Options Exchange (CBOE) Market Volatility Index (or VIX Index) to extremely low levels. As illustrated in Exhibit 2, the spot price (that is, the current market value of the VIX Index) is about as low as it gets. While some observers fear that the VIX Index is due for a sharp reversal, volatility can stay near these low levels for a long time. If the VIX Index does move sharply higher, it would likely be associated with an equity-market correction rather than a serious bear market (when stock prices sustain a peak-to-trough decline of more than 20%); bear markets usually only occur when the economy is approaching the onset of recession. That said, we would argue that the current ultra-low level in the VIX Index increases the odds of at least a garden-variety correction, which we define as a peak-to-trough decline ranging from 5% to 10%.

Exhibit 2: Volatility…Volare, Oh-oh-oh, Oh!



Source: CBOE, S&P, SEI

Exhibit 3: Crying Time



Source: Ned Davis Research, Standard & Poor's, SEI

One can certainly make the argument that this market is overdue for some sort of pullback. Ned Davis Research (NDR) recently updated a study of all price corrections within the S&P 500 of at least 5% since 1928. There have been 303 such corrections in total, which works out to an average of 3.4 per year. The last dip in the S&P 500 Index of 5% or more occurred as a result of the UK Brexit vote in June of 2016. If you blinked, you might have missed it, since it lasted only two sessions. This is illustrated in Exhibit 3, which breaks down the corrections by size of their peak-to-trough decline using NDR's nomenclature: a "dip" (a price drop of 5% or more), a "moderate correction" (a 10% or more decline), a "severe correction" (15% or more decline) and a "bear market" (more than 20% decline). Exhibit 3 also highlights the probabilities of a correction moving to the next, more serious, stage (for example, a dip of 5% to 10% has turned into a moderate correction of 10% or more almost a third of the time). The last correction of more than 10% occurred during the November 2015-to-February 2016 time frame. Moderate corrections have occurred about once per year, on average.

In some ways, the stock market can be likened to earthquakes and volcanic eruptions. Despite the outward calm, there can be plenty of activity below the surface, with stresses building up over time. It's not a question of whether a correction will take place; it's simply a matter of timing and magnitude. In our opinion, the pressure below the surface of the equity market is starting to build. Stresses, however, haven't built up to the point where a major market quake is likely. Rather, we would expect a more modest trembler, with the timing not at all certain.

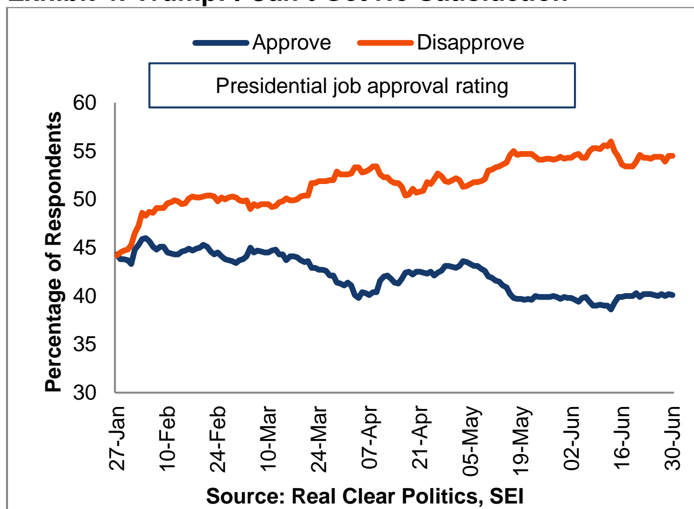
The Outlook Isn't Bad—It's Just Not as Good as It Was

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 viewed Donald Trump's electoral victory in the US as an opportunity to break the legislative logjam that had prevented the passage of business-friendly tax and regulatory reforms under former US President Barack Obama. We thought the US and global economies would accelerate, and expected equities and other risk-oriented financial assets to maintain the strong performance that had been sparked by the election outcome.

Our hope for a legislative-policy breakthrough now appears naïve, to put it nicely. We recognised from the day he became President-elect that Trump would be one of the most controversial personalities to ever have been elevated to the White House—and that the goodwill typically extended to presidents at the start of their first term would not be given to POTUS 45. When he entered

office in January, Trump's approval and disapproval ratings both stood at about 44%, according to Gallup[1]. These were historically poor initial numbers; since Harry Truman's Inauguration Day in 1945, all other presidents have entered office with approval ratings of at least 50%. Even more stunning has been the deterioration of Trump's already-poor numbers in the weeks since he ascended to the presidency (Exhibit 4). As of June 30, according to the Real Clear Politics average of presidential approval polls, only 40% of respondents approve of the job President Trump is doing, while 54% disapprove. These are the kinds of readings more typically seen toward the end of an unpopular president's second term or during periods of economic turmoil.

Exhibit 4: Trump: I Can't Get No Satisfaction



Source: Real Clear Politics, SEI

The Republican president's unpopularity—especially among Democrats, who, according to Gallup, registered a single-digit approval score—has emboldened his opposition to put up a unified resistance. Although 25 members of the Democratic Senate are up for re-election in 2018 compared with nine Republicans, all are hanging tough against the most impactful legislative items on the Republican agenda. And, despite the Democrats' Senate-minority status and inability to vote down the president's cabinet and sub-cabinet personnel appointments, the opposition party has still been able to throw sand into the gears of the vetting process. Additionally, Trump has yet to nominate anyone for 85% of the positions within the Administration requiring Senate confirmation[2]. Given this internal disorganization within the White House and the myriad distractions (from Russia with love ♪) that reduce the day-to-day effectiveness of the president and his team, the lack of "boots on the ground" across the bureaucracy has slowed the pace of legislative and rule-making activity to a crawl.

Of course, it's not just the White House kicking own goals or Democrats fighting tooth-and-nail against almost everything that is proposed by the executive branch. The Republican-controlled Congress also has tied itself in knots, highlighting the ideological and geographic divisions that exist within the Grand Old Party itself. The inability to push through health care legislation in a timely fashion has not only made a bad national problem worse; it also has complicated passage of a tax-reform bill.

Although our optimism is being sorely tested, we are gamely sticking to our expectation that a major tax bill will be pushed through the Congress by the arcane process known as reconciliation, which allows for simple majority voting in the Senate on tax and budget issues. Original hopes of a big cut in corporate statutory marginal tax rates to a maximum of 15% or 20% will most likely be disappointed; although a top corporate tax rate around 25% versus the current 35% is still possible, in our estimation. Individual tax cuts also will likely be tempered, since we see little possibility of major deductions for state and local and property taxes being eliminated. However, even this may prove to be a politically bruising battle. Republicans in the Senate may need to change the rules that currently prevent a reconciliation bill from increasing the US budget deficit without a supermajority of 60 votes.

If nothing else, US politicians of all stripes recognise that their jobs are in jeopardy when they appear ineffective or out of touch with their constituents. If Republicans continue to dither as they have in these past several months, they could face a voter backlash during the mid-term elections of 2018. Although it's highly unlikely that the Senate will change hands in 2018, the House certainly is in play. Recent special elections to replace congressmen who left the House to join President Trump's administration have seen reduced Republican support. The prospect of Democratic Representative Nancy Pelosi regaining the Speaker's gavel may concentrate the minds of factions within the Republican Party to mobilise.

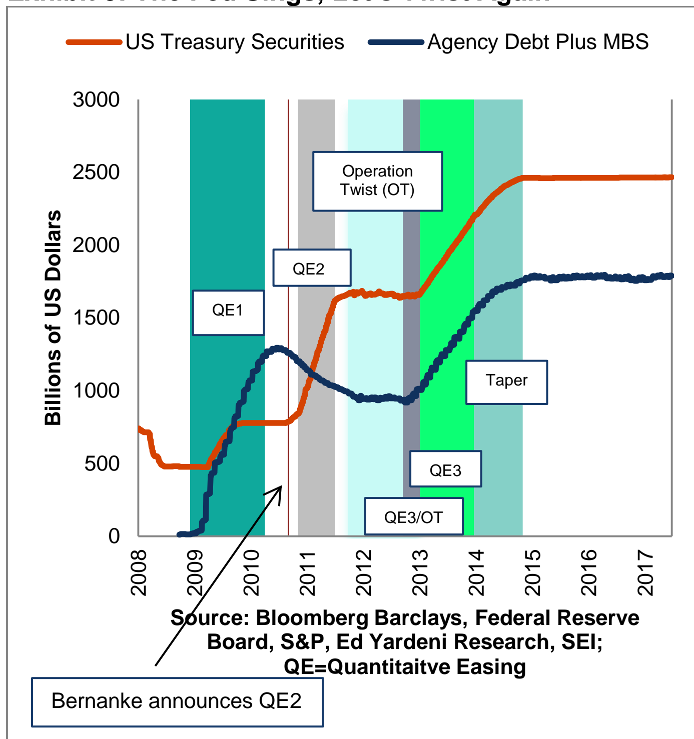
The end result of the US budget drama will likely be a tax and spending bill that is, on balance, stimulative. We see little chance that Republicans will be able to agree among themselves on all the major elements needed to offset revenue loss from tax-rate reduction. This should boost the prospects for economic growth; but since it comes at a time when the economy is edging closer to full employment, this fiscal stimulus could eventually add to inflationary pressures.

We suspect US Federal Reserve (Fed) Chair Janet Yellen and a majority of her colleagues are coming to the same conclusion, based on their decision to raise the federal

[1] Gallup: Trump Sets New Low Point for Inaugural Approval Rating
[2] Lawfare: Can President Trump Just Leave Key Executive Branch Offices Unfilled?

funds rate for the second time this year and, more importantly, announce how the central bank will reduce its balance sheet. The pace of quantitative tightening should not be exceptionally disruptive to the bond market, at least during its ramp-up phase. Once the process begins, it will take a year to get up to full speed—with a monthly runoff of $30 billion of Treasury bonds and $20 billion of mortgage-backed securities. This works out to a runoff of 1.2% per month of the Fed's current holdings of both types of securities, and amounts to an annualised flow equivalent to 3% of gross domestic product (GDP). Exhibit 5 shows the Fed's Treasury-bond and mortgage-backed-security holdings since 2008.

Exhibit 5: The Fed Sings, Let's Twist Again

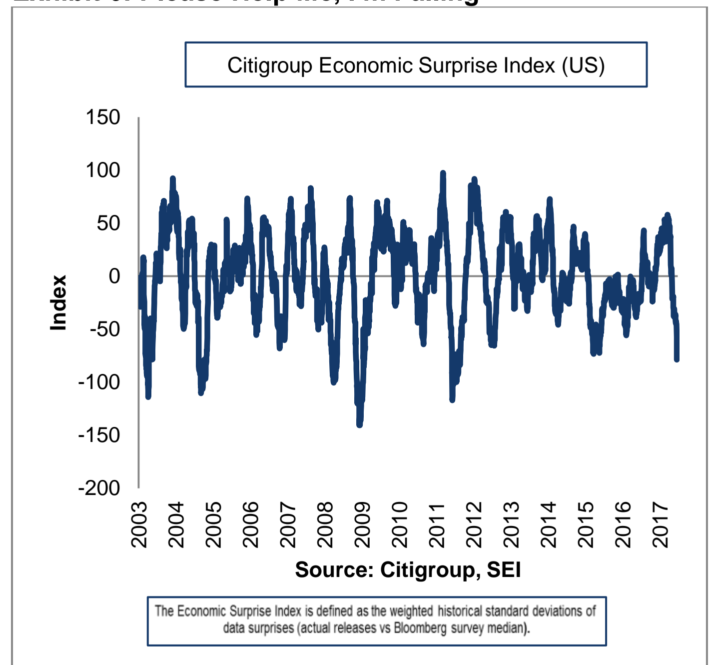


Source: Bloomberg Barclays, Federal Reserve Board, S&P, Ed Yardeni Research, SEI; QE=Quantitaitve Easing

Crucially, the Fed did not reveal how long it will take to normalise its balance sheet. Fed-watchers speculate the central bank will reduce its balance sheet by at least $1 trillion worth of securities, and perhaps as much as $2 trillion over the next few years. According to a recent Fed press release, "…securities holdings will continue to decline in a gradual and predictable manner until the Committee judges that the Federal Reserve is holding no more securities than necessary to implement monetary policy efficiently and effectively." In her press conference after the Fed announcement, Chair Yellen likened the balance sheet runoff as running in the background and being as boring as watching paint dry. We hope that characterization is correct. But if fiscal stimulus adds to the budget deficit and investors suddenly become more concerned about the inflation outlook, the Fed's absence from securities markets could aggravate the upward pressure on bond yields (yields move inversely to prices). However, with the 10-year Treasury bond currently yielding just 2.30%, it is obvious that inflation concerns are not yet paramount among fixed-income investors.

The other unknown is exactly when the Fed will begin the quantitative tightening program. In her testimony on June 14, Yellen surprised the markets by saying it would commence "relatively soon"—against our assumption that it would start in 2018. Now it appears that the central bank will begin the process by September. We view this accelerated timetable as significant since it appears Fed policymakers are "looking through" the current weaker-than-expected economic numbers. Exhibit 6 shows the magnitude of negative surprises versus expectations recently reached its most extreme level since 2011, according to Citigroup's widely followed Economic Surprise Index for the US. Although this statistic is highly cyclical, such a negative data flow in previous years would have deterred the Fed from tightening monetary policy. Now, however, policymakers seem willing to look further into the future, to a time when tight labour markets start to exert an upward impact on wages and inflation.

Exhibit 6: Please Help Me, I'm Falling



Source: Citigroup, SEI

As has been the case for some time, forecasts of the US Federal Open Market Committee (FOMC) show real economic growth accelerating very little beyond 2% between now and the end of 2019. Inflation, as measured by the personal consumption expenditures index, also is projected to remain near a 2% rate. Meanwhile, the FOMC expects to raise the federal funds rate one more time this year, followed by three increases in 2018 and another three in 2019, with the policy rate reaching 3% by the end of 2019. Investors still think the FOMC forecasts are much

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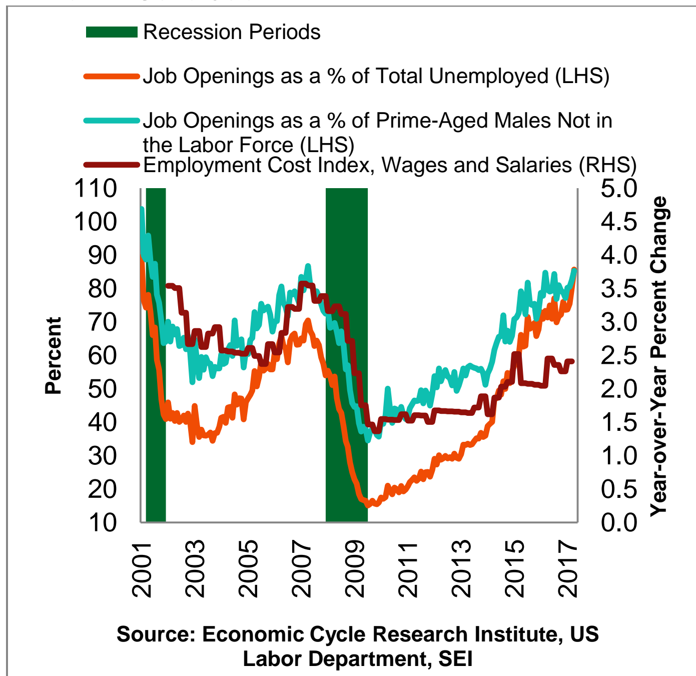
too aggressive with regard to the federal funds-rate projection. The federal funds' futures curve implies a probability of 75% for one additional 25 basis-point rise in the federal funds rate between now and June 2018, and only a 32% likelihood of two or more hikes.

One of the great puzzles of this cycle is the lack of upward pressure in the inflation rate despite the tightening labour market. According to the US Department of Labour, job openings in the US exceeded six million in April—a new high for this economic cycle. The number of total unemployed and males not in the labour force versus the number of job openings has reached a level not seen since 2007 and, before that, 2001. Yet wages and salaries, as measured by the Employment Cost Index, continue to rise at a sedate pace. As a result, corporate profit margins remain unusually robust despite the economic expansion having entered its eighth year. This is illustrated in Exhibit 7, which looks at job openings as a percentage of the total number of the officially unemployed (that is, not working but looking for a job) and as a percentage of prime-aged males (25-to-54) not in the labour force—a demographic that has become a major policy concern due to the cohort's waning workforce participation rate.

Exhibit 7: Get a Job

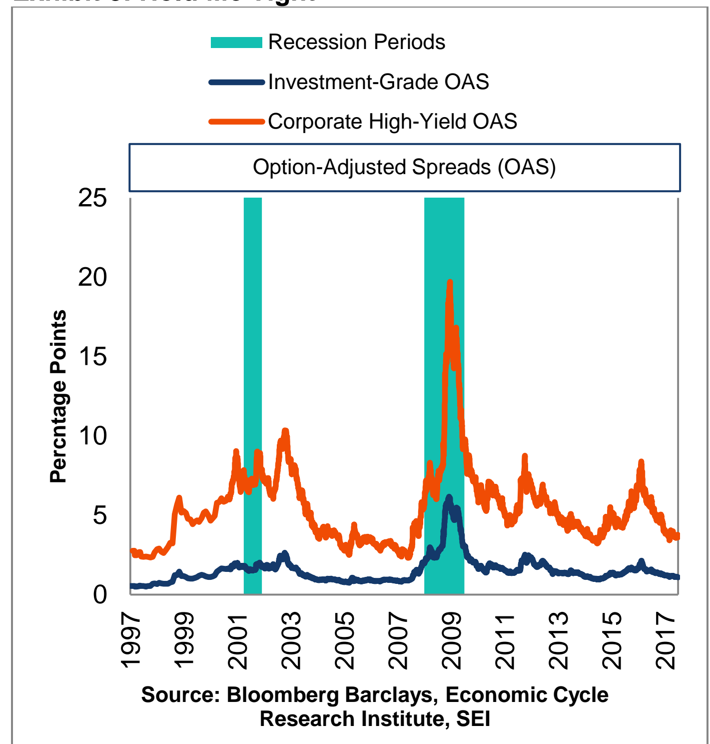


Source: Economic Cycle Research Institute, US Labor Department, SEI

The connection between tight labour markets and wage inflation has seemingly been severed by stubbornly slow economic growth; little visible progress on tax reform and fiscal policy stimulus; weak oil pricing as US shale production makes a comeback; 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 for us to see the value in investments that, at best, only approximate the inflation rate in the long run. Fixed-income yields are low in absolute terms; and credit spreads are tight relative to Treasury bonds (Exhibit 8). We do not think this lack of value portends imminent danger since inflation also is still low, even as the Fed continues to tighten monetary policy in a slow and methodical fashion. It does, however, as we noted above regarding the VIX Index and equities, increase the vulnerability of fixed-income assets to a negative surprise.

Exhibit 8: Hold Me Tight



Source: Bloomberg Barclays, Economic Cycle Research Institute, SEI

Given this, we're not surprised that US equities, as measured by the MSCI USA Index (Total Return), have lagged both developed- and emerging-market equity benchmarks in the year to date. In fact, the underperformance of US equities versus the MSCI Emerging Markets Index (Total Return) extends as far back as January 2016, when measured in U.S dollars. 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 against the rest of the world will prove transitory too. But we no longer view US equities as the best game in town.

Our US large- and small-cap portfolios are defensively positioned. Value-oriented holdings have been trimmed. We have increased the weighting of managers that emphasise stability and sustainable growth. Cash as a percentage of each portfolio is generally at the higher end of the normal range. The conditions that should help our

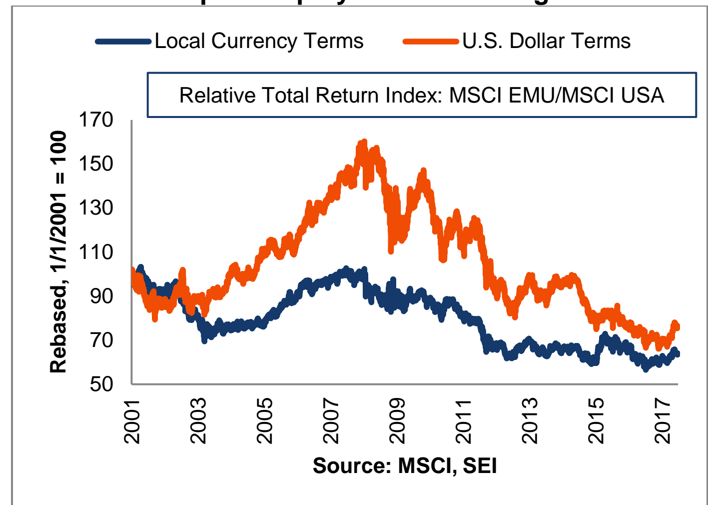
US large- and small-cap portfolios beat their benchmarks include: (1) a return of investor focus on earnings and valuation instead of sentiment; (2) better-than-expected earnings growth; (3) moderate inflation that translates into pricing power for well-run companies; and (4) a return to a market that is more favourable for active management. This last condition includes factors such as low stock correlation and higher dispersion.

In our fixed-income portfolios, our external managers continue to seek yield enhancement. They are overweight the debt of banks and other financial companies, while also emphasizing asset-backed securities (credit cards, commercial properties). Our core managers are starting to reduce risk, however. In the high-yield area, our positioning is underweight duration (that is, less exposed to interest-rate risk) and overweight yield relative to the benchmark. The energy sector is a notable underweight. Cash holdings are up slightly; our managers are inclined to raise cash levels slightly further, given the dearth of opportunities currently prevailing in the market.

A Rare Case of Euro-phoria

There's no denying that investors in European equities have had a rough few years: in local-currency terms, they have lagged the US stock market since 2007, finally hitting bottom in August 2016. Thus far in 2017, the European recovery in relative performance has been mild—for the happy reason that the US stock market itself is up by about 10%, as measured by the MSCI USA Index (Total Return). The bounce in the MSCI European Economic and Monetary Union (EMU) Index (Total Return) has been far stronger in the year to date in US dollar terms, reflecting the strength of the euro against the greenback. The euro's multi-year appreciation against the US dollar accentuated the MSCI EMU Index (Total Return) relative performance to the upside from 2003 to 2007; the collapse of the currency aggravated the decline in the years after 2007. Exhibit 9 highlights the relative strength of the MSCI EMU Index (Total Return) against its MSCI USA (Total Return), in local and US dollar terms.

Exhibit 9: European Equity: Kind of a Drag

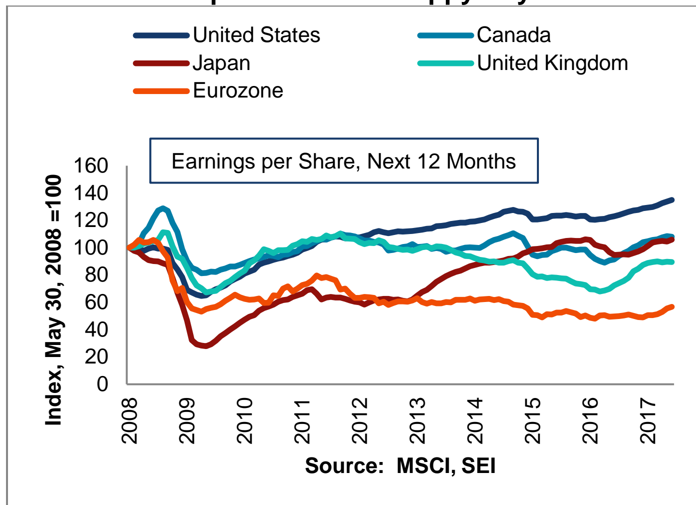


Improving economic fundamentals have provided a good foundation for the equities rally in Europe—where business sentiment has risen to the highest level since 2007, suggesting that economic growth may soon accelerate beyond the 2% pace of recent years. Business-sentiment indicators have improved in most countries, even Greece. The services sector has been the most buoyant, while construction and industrials appear to have logged the strongest rebound in terms of expectations. Consumer sentiment across countries has been less uniform—strongest in Germany and Spain, improving sharply in France but continuing to deteriorate in Italy.

The Organization for Economic Cooperation and Development's (OECD) index of leading economic indicators tells a similar story. The four largest countries (Germany, France, Italy and Spain) have been exhibiting above-trend growth. However, Italy appears to have been fading by this yardstick. In contrast, the US and UK have both been growing at a below-trend pace and appear to be decelerating.

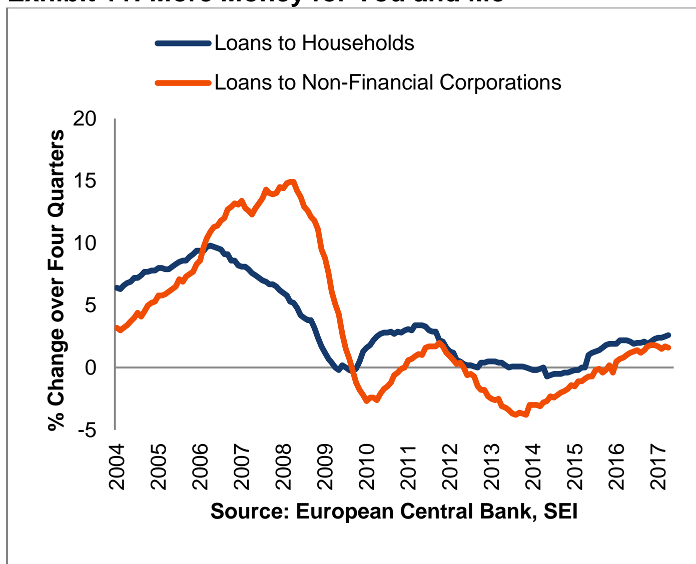
Most importantly for investors, eurozone earnings have finally begun to pick up. MSCI EMU Index companies' year-over-year earnings per share (EPS) were up by 14%, on a sales gain of 4.5%. The eurozone still appears set to lag on a 12-month forward EPS basis, when measured against other major countries from the peak of the previous earnings cycle in 2008 (Exhibit 10). But the profits recovery seems to have strong momentum behind it.

Exhibit 10: European EPS: Oh Happy Day



From a monetary perspective, the European Central Bank's (ECB) expansion efforts seem to have had a positive impact—finally. As Exhibit 11 highlights, loan growth to businesses and households has accelerated to the best pace in six years (albeit still muted compared to the years before the global financial crisis). This encouraging-yet-slow expansion in credit argues strongly in favour of ECB President Mario Draghi's long-standing preference to maintain the current pace of quantitative easing at least through the end of the year. However, the shortage of German bunds is expected to force the ECB to taper its bond purchases sooner rather than later. While we anticipate that the central bank will maintain its negative-interest-rate policy well into 2018, Draghi's rhetoric has suddenly became more hawkish in tone. This has provided a modest boost to bond yields and has caused the euro to jump higher against other currencies.

Exhibit 11: More Money for You and Me



The good economic news has been matched by good political news—especially in France, where recently elected President Emmanuel Macron and his new Le Republique en Marche party have swept into power. Macron's victory opens the way for much–needed economic reforms that promise to increase the country's labour-market flexibility, reduce government spending in relation to the size of the economy and increase the vibrancy of the private sector. Of course, France is France. Reforms will not likely be met by the opposition with a simple shrug of the shoulders. Industrial action and street protests will greet the changes, much like the unrest former UK Prime Minister Margaret Thatcher faced during the early 1980s when she overhauled Britain's economic and social structure. We will see how both President Macron and the financial markets react when the protests come.

SEI's equity managers are still positive on Europe; although they expect price movements to be muted over the summer, since they judge markets to be fairly valued. They favour momentum factors, with the crowded trades of last year dissipating and valuation dispersions reverting to more normal levels. A rotation out of value managers is underway. Stability is still viewed as being on the expensive side; although the extent of the overvaluation is much reduced versus year-ago levels. The periphery of Europe (Spain, Portugal and Italy) is overweighted, consistent with the view that economic and political concerns have faded into the background, at least for the time being.

Our fixed-income managers are not attracted to European securities, as extremely low yields continue to prevail. Valuations have become more demanding, with more good news priced in and less margin for error. However, overweighting credit remains a general theme.

The UK is Not A-OK

"Yesterday, all my troubles seemed so far away/Now it looks as though they're here to stay/Oh, I believe in yesterday" -Yesterday, The Beatles

We would not be surprised if British Prime Minister Theresa May and her Conservative Party colleagues have been humming this mournful tune over the past few weeks. When May called for a snap election at the beginning of April, it looked to be a savvy move that would give her party an unassailable majority in the Parliament and a clear mandate to drive a hard bargain on Brexit. But her game plan was upended by a poorly conducted campaign, an ill-advised austerity reform that was nick-named "the dementia tax," and an upsurge in the participation of younger voters who are hostile to the notion of leaving the European Union (EU). The government was forced to engage with the Democratic Unionist Party (DUP) in a confidence-and-supply

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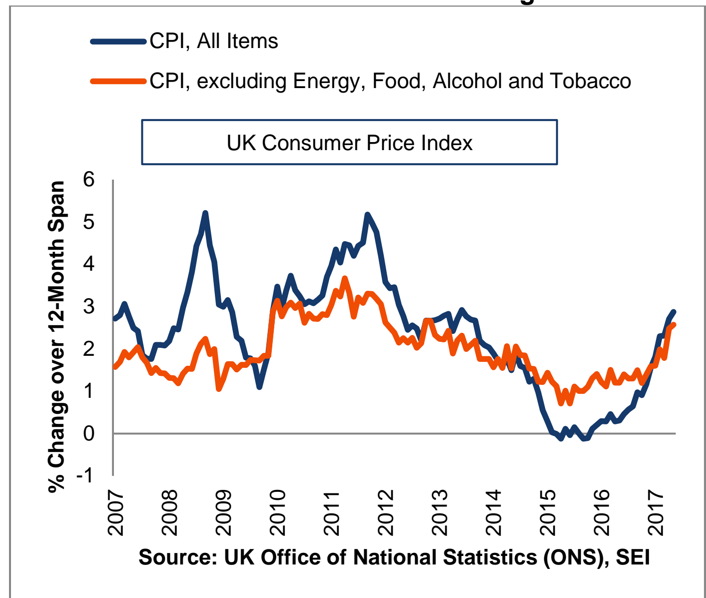
agreement in order to remain in power. The arrangement is less formal than a coalition, but still enables May to form a minority government

The surprising election result probably will not stop Brexit from happening. The opposition Labour Party did not campaign on a program of rolling back last year's referendum result. But the setback in the Conservative Party's fortunes probably will change the broad outlines of the final divorce agreement. The UK is now far more likely to move in the direction of a "soft" Brexit, which would keep more economic and political ties to the EU intact than previously envisioned. But the EU now holds the negotiating advantage and can therefore be expected to prevail in its primary objectives, including: the free movement of legal residents between the EU and the UK; a continued role of the European Court of Justice in adjudicating EU-U.K disputes; ongoing contributions from the UK to the EU budget; and the maintenance of an open border between Northern Ireland (part of the UK) and the Republic of Ireland (part of the EU)—a key demand of the DUP. In other words, the UK will have to accept a hybrid relationship that still limits control over its own border and obligates the country to follow certain EU rules and regulations—without the ability to influence those rules and regulations, since the country will no longer be a full member of the Union.

We believe there is a silver lining to all this. In our view, U.K services industries and the City of London have more to gain from a hybrid relationship with the EU than from a complete sundering of the relationship (as is the wish of more hard-line Brexiteers). Also, the diminished post-election standing of the Scottish National Party dealt a big blow to the Scottish separatist movement. While separatist sentiments will not disappear, the movement now can be compared to the Quebec sovereignty camp in Canada—a rallying cry for the disgruntled, but a dream with no near-term possibility of being realised.

The latest political surprises come at a time when the UK economy is showing mixed economic results. Both headline and core consumer-price inflation have been accelerating over the past year, running closer to 3% than the Bank of England's (BOE) target of 2% (Exhibit 12). This move upward in the inflation rate reflects, in part, the pass-through costs of imported goods. It can be traced directly to sterling's 20% decline since August 2015. The rebound in energy prices over the past year is another reason; although the recent stumble in the oil markets should mitigate this particular factor in the months ahead. In any event, the rise in inflation has not been matched by rising incomes—UK households are falling behind, even though the unemployment rate has dropped to its lowest level in more than 40 years. The squeeze on UK households might be another reason why the May government was given a good, swift kick by the electorate.

Exhibit 12: UK Inflation: Bad Moon Rising



Source: UK Office of National Statistics (ONS), SEI

The BOE appears to be taking a hawkish turn. Three out of eight Monetary Policy Committee (MPC) members voted in June to raise the base rate by 25 basis points, expressing concern that the BOE is falling behind the inflation curve and that the UK economy is now running close to full potential. In their opinion, these considerations warrant tapping on the brake—even in the face of declining household real incomes, economic uncertainties surrounding Brexit and the domestic political troubles. Shortly after the MPC meeting, BOE Governor Mark Carney made clear that the majority has little appetite for tightening monetary policy at this time; although, like ECB Governor Draghi, his remarks have since grown more hawkish. In any event, the BOE already has announced an increase in capital buffers for banks as a precaution.

There is no denying that these are uncertain days for Britain. The MSCI United Kingdom Index (Total Return) has lagged the MSCI Europe ex-UK and MSCI USA Indexes (Total Return) by 5.3 and 4.9 percentage points, respectively, in the year-to-date through June 30, in local-currency terms. In the bond market, 10-year UK government gilts yield only 1.26%. That might look attractive versus Germany's 0.46%, but it is considerably less than the 2.30% yield prevailing in the US. When taking inflation into account, the gilt yield in real terms amounted to a negative 1.55% (Exhibit 13). Even Germany looks to be a better value at this moment. Our international equity and fixed income managers are therefore underweight UK assets versus the benchmark, and are waiting to see how the Brexit negotiations evolve.

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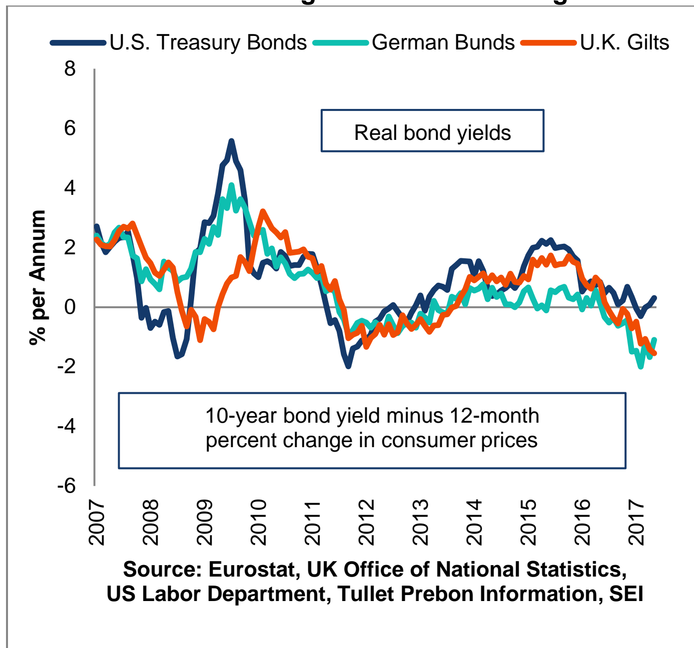
Exhibit 13: Ain't Nothing Like the Real Thing



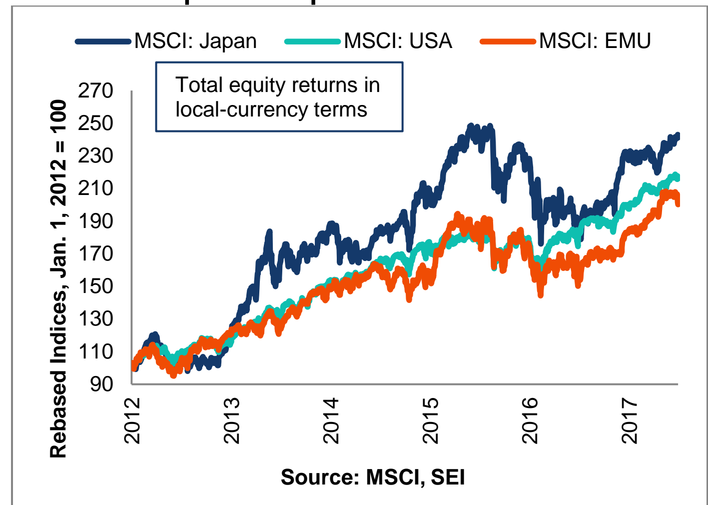
Source: Eurostat, UK Office of National Statistics, US Labor Department, Tullet Prebon Information, SEI

Japan's Day in the Sun?

If a trophy were given out for the most underrated stock market, we would give our vote to Japan. It is no secret that its economy faces serious demographic issues. As implausible as it may sound, the OECD projects that Japan's population will decline by more than 30% over the next 40 years as a result of an extremely low birth rate and little in the way of net migration into the country. The median age of Japanese citizens (46.9) is well above that of the US (38.1), the UK (40.1), Canada (40.7) and France (41.4). This demographic headwind has led to extremely slow inflation-adjusted GDP growth of about 0.4% per annum over the past 10 years and a prolonged struggle with falling consumer prices.

Yet Japanese equity prices have outperformed both US and European equities since 2012, when Prime Minister Shinzo Abe entered office (Exhibit 14). Since the start of 2012, the MSCI Japan Index (Total Return) has gained a cumulative 141% in local-currency terms—a compound annual rate of 17%. Over the same time span, the MSCI USA and EMU Indexes (Total Return) advanced a cumulative 116% (15% per annum) and 100% (13% per annum) in local-currency terms, respectively.

Exhibit 14: Japanese Equities: Leader of the Pack



Source: MSCI, SEI

Japan's surprisingly strong stock-market performance reflects investor optimism that Prime Minister Abe's reform efforts will bear fruit over time. The governance of large, publicly traded companies in Japan has improved quite a bit. Returns on equity have risen from 7.13% in February 2012 to 8.70% in May 2017, according to index provider MSCI. Over this same period, the return on investment of companies within the MSCI World ex-Japan Index fell from 14.34% to 14.02%. Dividend growth is accelerating sharply, while corporate buybacks are becoming more common. The Japanese government has been working hard to open markets that have been protected from competition—which is why Japan is still trying to push the Trans-Pacific Partnership despite the US having withdrawn from the agreement.

Another factor behind the strong performance of Japanese equities stems from the liquidity infusion into the economy provided by the Bank of Japan (BOJ) through its quantitative and qualitative easing (QQE) program. Japan's central bank has been an aggressive buyer of securities compared to the US and Europe (Exhibit 15). As a percentage of GDP, the BOJ's holdings (including equities, real-estate investment trusts and exchange-traded funds, as well as debt) are almost as large as the economy itself. Although there is speculation that the central bank might begin to taper its asset purchases in 2018, persistently low inflation decreases the likelihood of the QQE program ending any time soon.

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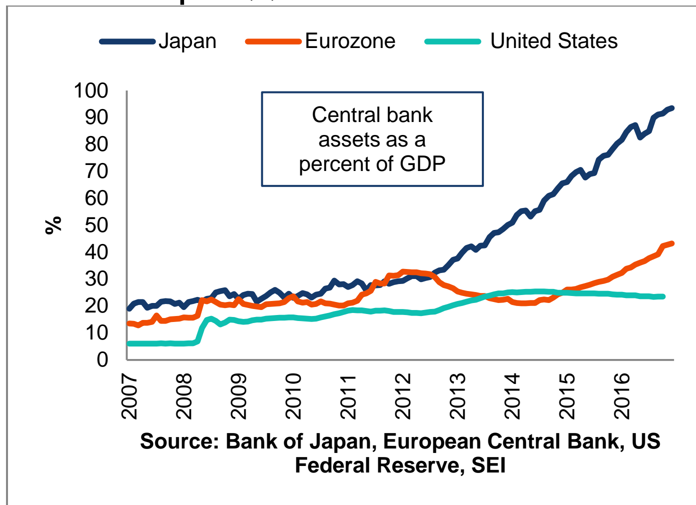
Exhibit 15: Japan QQE: Take a Walk on the Wild Side



Source: Bank of Japan, European Central Bank, US Federal Reserve, SEI

The BOJ has been targeting its 10-year bond yield near the 0% mark since September 2016 as another element of its extraordinary monetary experiment. As economic growth has picked up and deflation has eased, the short end of the yield curve has flattened, while the long end beyond the 20-year maturity has steepened. Compared against the yield curve as it existed one year ago, interest rates remain low across the maturity spectrum, especially at the long end. As long as the BOJ anchors the yield curve at the 10-year mark, we think interest rates can only move so high at either end of the curve. With rates in the US moving up and the differential versus Japanese yields widening, we look for 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.

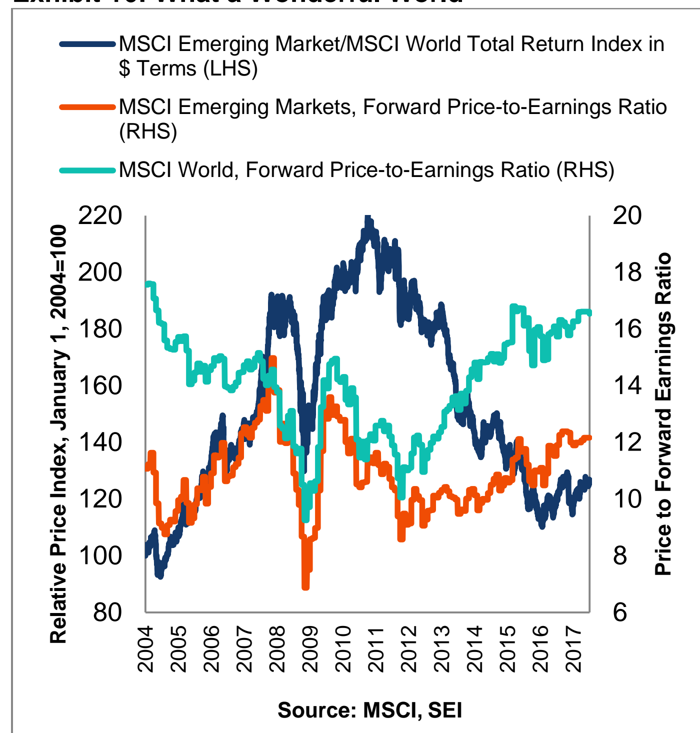
Our Pacific-basin-based equity managers are bullish on the market. They continue to overweight cyclical sectors while underweighting financials and energy, as they have for a few quarters now. In terms of alpha factors, our managers still emphasise value, while avoiding companies that display stability characteristics. They prefer Japan and emerging-Asian markets (such as Singapore and Hong Kong) and are underweight Australia (which is seen as too dependent on China). In addition, Australia's big banks have been downgraded by credit agencies on fears of deteriorating loan quality.

Emerging Markets: Great Ball of Fire

Developing-market equities have been on a tear this year, with the MSCI Emerging Markets Index (Total Return) climbing almost 19% in US dollar terms in the year to date, and a still-substantial 15% when measured in local-currency terms. The strong first-half performance builds upon a creditable gain in 2016, when the US dollar and local-currency-denominated benchmarks appreciated about 10% in absolute terms.

Despite the gains, emerging stock markets still look attractive on a valuation basis. As illustrated in Exhibit 16, the improvement in emerging stocks relative to the MSCI World Index began in early 2016, when risk assets of all types around the globe hit ultimate lows. The move higher in emerging markets, however, has been ragged, punctuated by a sharp correction immediately following the US presidential election. Valuations, as measured by the 12-month forward price/earnings ratio, have been rising in recent years, from under 10 times in 2013 and 2014, to 12.2 times by the end of June. By comparison, the price/earnings ratio on the MSCI World Index reached a lofty 16.5 times; the resulting spread of 4.3 multiple points is narrower than it had been in 2015, but remains notably wide in the context of the past 10 years.

Exhibit 16: What a Wonderful World



Source: MSCI, SEI

Attractive valuations relative to developed markets are not the only draw for investors. Global economic fundamentals are improving too. Purchasing-manager reports for emerging countries point to a broad and fairly solid recovery. China has led the way, while even Brazil has improved sharply as its economy works its way out of recession. The global economic upswing and a somewhat weaker US dollar have also pushed commodity prices higher. As Exhibit 17 shows, spot commodity prices have been rising since 2016, reversing a two-year decline. The correlation between the Commodity Research Bureau's (CRB) spot price index for raw materials and the earnings trend of developing-market companies has been close over the years. 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

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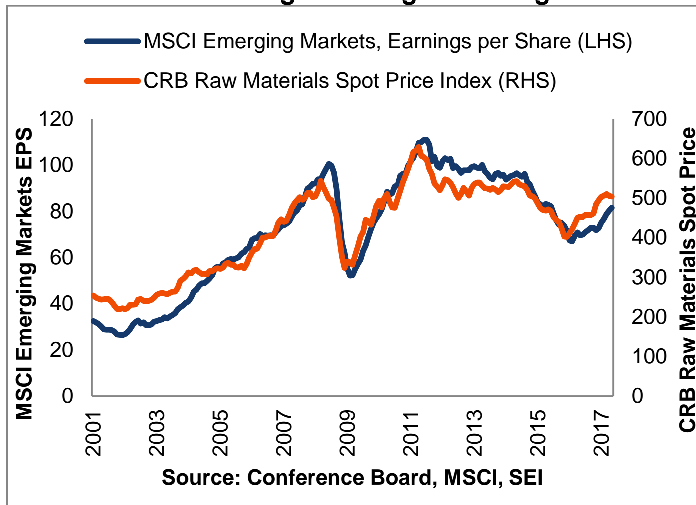
slightly weaker US dollar—all of which provide a favourable macroeconomic backdrop for emerging-market economies and financial markets.

Exhibit 17: EM Earnings Coming on Strong

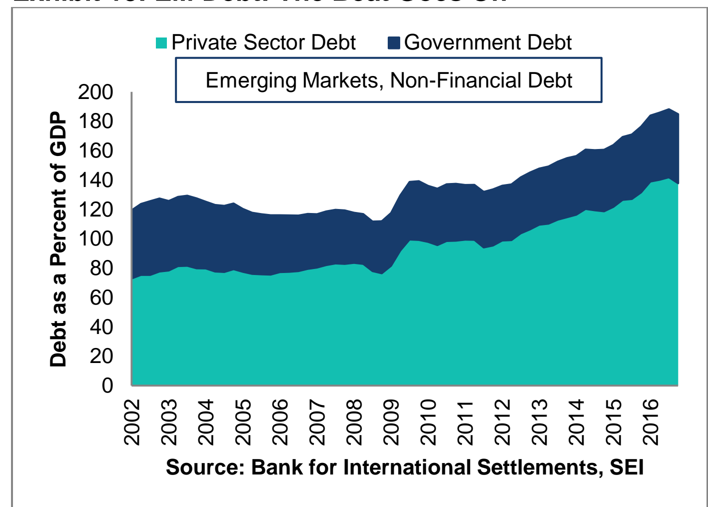


Source: Conference Board, MSCI, SEI

Our emerging-market equity managers continue to favour Latin America despite the political turmoil in Brazil. They tend to be underweight the larger Asian countries (China, South Korea and Taiwan).

We remain concerned about the sharp increase in debt across developing economies. Since the end of 2008, emerging-market debt as a percentage of GDP has risen from under 112% of GDP to almost 185% (Exhibit 18). Much of that debt increase has been tied to the corporate sector, especially in China, where private, domestic, non-financial debt has reached an eye-watering 211% of GDP. That's almost double the share of GDP recorded at the end of 2008, according to the Bank for International Settlements.

Exhibit 18: EM Debt: The Beat Goes On



Source: Bank for International Settlements, SEI

Emerging-market bond investors are still dancing, however. The option-adjusted spread on US dollar-denominated bonds is down to 2.68 percentage points, a sharp contraction from its recent cyclical high of 4.79 percentage points in February 2016. That is about as narrow as this spread has ever been, outside of the 2006-to-early-2007 period. At this point, our managers favour local-currency debt over the dollar-denominated variety. Argentina, a serial defaulter throughout its history, recently scored a major coup by selling a high-yielding 100-year US dollar-denominated bond. Perhaps this obligation will be paid off in full when it matures. We hope to be around to see that day.

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