# Economic Outlook

Third Quarter 2017

SEI New ways. New answers.®

## (Almost) Always Look on the Bright Side of Life

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

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ROBIN (spoken):
Bring out your dead! Bring out your dead!
LANCE (spoken):
Here's one.
DAD (spoken):
I'm not dead!
ROBIN (spoken):
Here, he says he's not dead!
LANCE (spoken):
Yes he is.
DAD (spoken):
I feel happy. I feel happy.

(sung)
I am not dead yet
I can dance and I can sing
I am not dead yet
I can do the Highland Fling
I am not dead yet
No need to go to bed
No need to call the doctor
Cause I'm not yet dead.

*He Is Not Dead Yet*, a scene from "Spamalot," the Broadway adaptation of "Monty Python and the Holy Grail"

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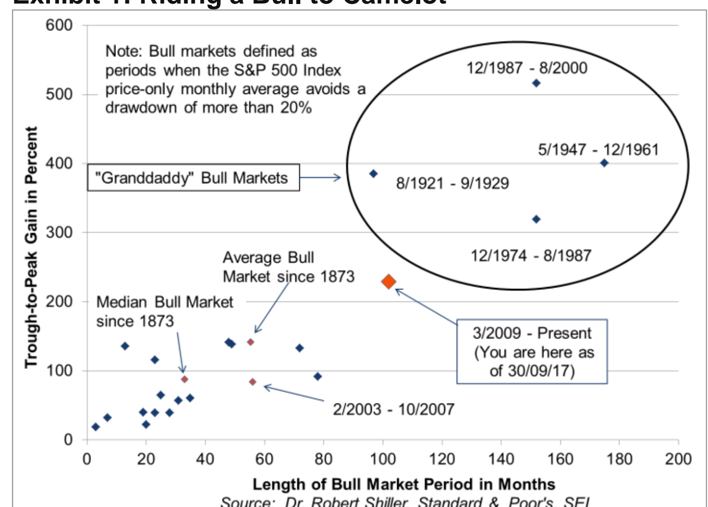
Neither the Black Plague, nor old age, nor a mighty whack on the head from his son Lancelot could keep Not Dead Fred from springing back to life. When you come down to it, the bull market in US equities is much like Fred—it refuses to die. Devastating Atlantic hurricanes like Harvey and Irma can't kill the bull. The spectres of another debt-ceiling tussle and US government shutdown, not to mention all-around political dysfunction, haven't done much to halt the market's rise. Even the deadly serious game of nuclear chess being played between North Korea's Kim Jong-un and President Donald Trump has failed to elicit much of a response.

The current bull market in US equities is now the fourth-longest in duration (102 months) since 1893. (We define bull markets as periods when the S&P 500 Index price-only monthly average avoids falling by more than 20%.) Its cumulative percentage gain is the fifth-highest, with the S&P 500 Index having appreciated by about 230% in price-only terms from its March 2009 low (Exhibit 1). This cycle is certainly getting closer to being considered a so-called granddaddy bull market—but still has a ways to go before setting any all-time records for either longevity or price appreciation. As Exhibit 1 highlights, the longest bull market on record occurred between May 1947 and December 1961, when the S&P 500 Index posted a cumulative gain of 400%. The biggest percentage gainer was the secular bull that began in December 1987 and ended in August 2000. That granddaddy bull recorded a trough-to-peak price-only gain of more than 500%.

**Exhibit 1: Riding a Bull to Camelot**



Source: Dr. Robert Shiller, Standard & Poor's, SEI

To be sure, all good things eventually come to an end. And the last thing we want to do is praise a bull if it's about to die. Yet, when we consider valuations, the upward momentum of the economy and earnings, and the likely path of Federal Reserve (Fed) policy and inflation, we still conclude that the bull market isn't dead yet.

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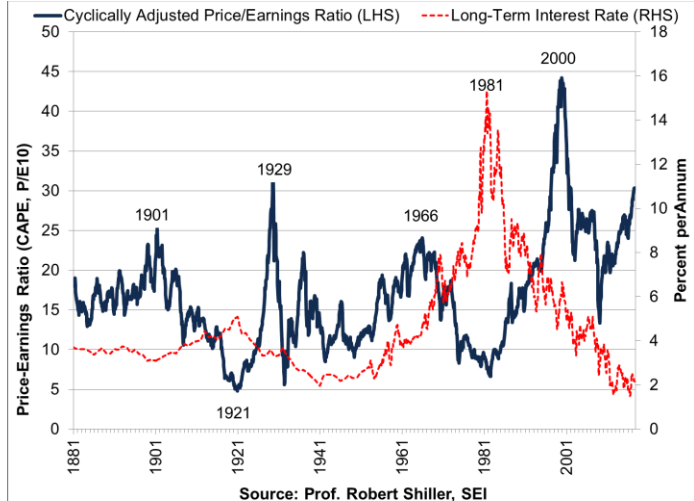
All charts and data to 30/09/2017 and are quoted in US dollars unless otherwise stated

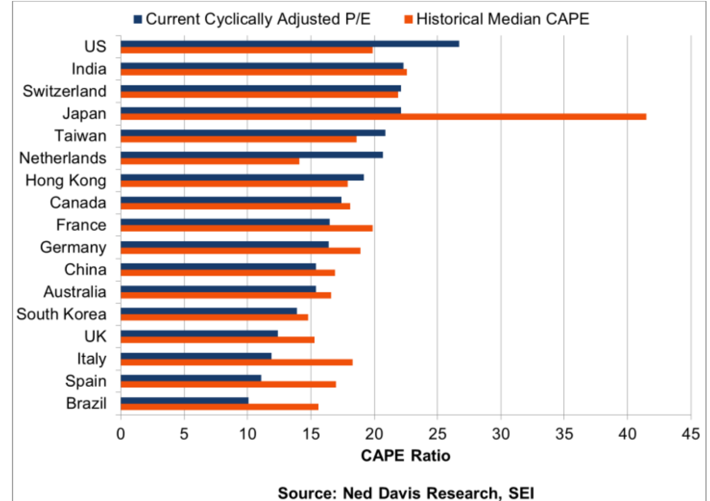
On the issue of valuation, there is no denying that US equities are trading at elevated levels. Exhibit 2 highlights the cyclically adjusted price-to-earnings (CAPE) ratio for the S&P 500 Index and its common-equity predecessors, as calculated by Yale University economics professor and Nobel laureate, Robert Shiller. This series extends all the way back to 1881. It is calculated by dividing the current stock price by the 10-year moving average of annualised reported earnings. Both the stock-price index and the earnings are adjusted for inflation in Shiller's methodology.

**Exhibit 2: CAPE Fear?**




US equities also appear relatively expensive when comparing the US CAPE with CAPEs of other countries (Exhibit 3). Indeed, most countries in the chart are on the cheap side, not only against the US but also against their own histories. This is one reason we currently favour international equity markets versus US equities. Countries that have had troubled economies—the European periphery and Brazil, for example—display exceptionally low absolute valuations. Japan has a high CAPE, but its current value is only half of its historical median value.

**Exhibit 3: Find Your Grail**




No one should be surprised that the CAPE has been trending higher for the past several years. Currently sporting a price-to-earnings ratio (P/E) of more than 30, the CAPE is at a level exceeded only by the peaks recorded in 1929 and 2000. While one can quibble with the methodology (for example, the most recent 10-year earnings window includes an earnings recession that was extraordinarily deep, thereby depressing the multiple's denominator), the CAPE is still high. Excluding the plunge in earnings during the 2007-to-2009 timeframe, the cyclically adjusted P/E would still be around 25 times. There is an important mitigating factor, however, that needs to be taken into account, which is also highlighted in Exhibit 2. That's the exceedingly low level of interest rates that currently prevails. Over the past four decades or so, there has been a strong negative correlation between bond yields and the CAPE. As interest rates zoomed higher during the 1970s, the CAPE tumbled—hitting a trough of only 6.6 times in 1982 as bond yields peaked in the mid-teens and then began to fall. The bond market, of course, has been on a bull run for a generation, with yields stabilising near record-low levels during the past few years. We believe this justifies a structurally elevated CAPE value. While US equity valuations are on the expensive side of the norm, we maintain that the exuberance displayed by investors is still of the rational variety.

A high cyclically adjusted P/E implies that the US equity market could be a performance laggard in the years ahead relative to other stock markets. What the CAPE cannot predict is an imminent downturn or bear market. The CAPE is a lousy timing tool, for the simple reason that expensive markets can get even more expensive. When the US CAPE breached 25 on the upside in previous periods (1928, 1996, 2003, 2014), there was still substantial appreciation to be reaped over the next several years (with the 1928 experience being the exception). Of course, such high values are rare in the history of the data. The lack of observations means we can't depend on the CAPE alone to judge when high is too high.

Stock-market declines of 20% or more are usually associated with recessions. Of course, there are a few exceptions to this rule, but they tend to be events that correct for previous excesses to the upside (1934, 1961, 1987) or are associated with major wars (1917, 1938 to 1942). As we pointed out in last quarter's *Economic Outlook*, dips and corrections can occur with frequency; some are tied to recessions, but most are not. We replicate the chart from our second-quarter report in Exhibit 4 because it provides a handy reference. As we noted then, dips (a price drop of 5% or more) occur 3.4 times per year, on average. We like to say that dips of 5% to 10% can happen "just because." These declines are mostly just noise, reflecting investors' over-sensitivity to the news of the day. Moderate corrections (10% to 15%)

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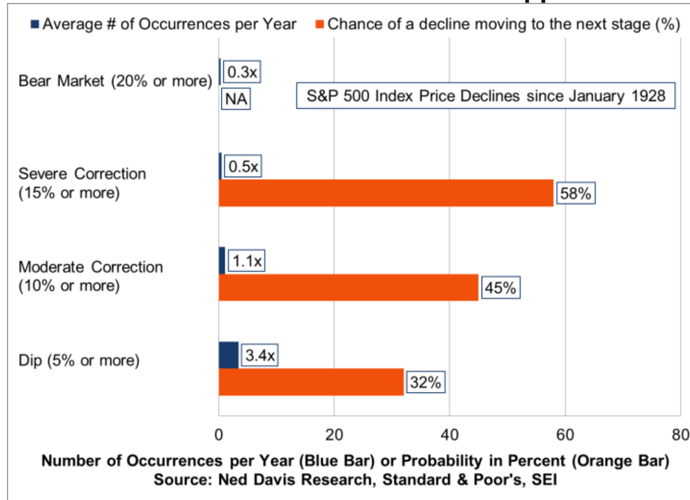
and those that are more severe (15% or more) usually have a sounder basis in fundamentals, and are caused by economic or political shocks and disappointments. For investors holding excess cash, we tend to view these as buy-on-the-dip opportunities—as long as we think the odds of recession are still low. This strategy worked well during 2011 and early 2016.

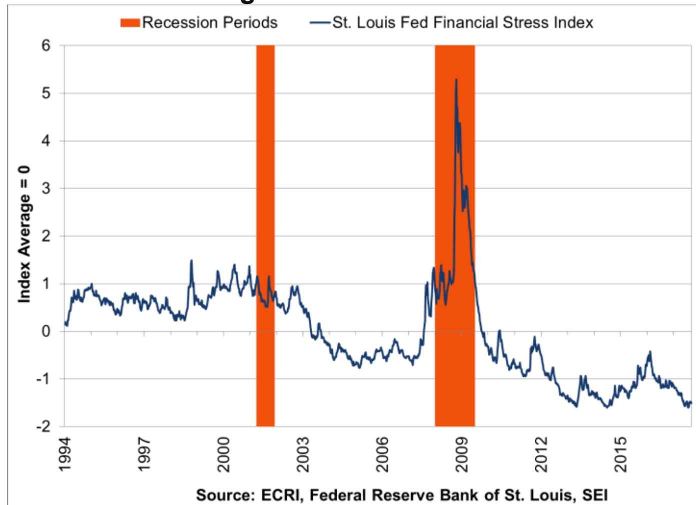
**Exhibit 4: When Markets Get Fisch-Schlapped**



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

And so, the overriding question among investors is a simple one: Is a recession on the horizon? We are confident that the answer is "no." First, financial stress, a harbinger of recession, is virtually non-existent. One comprehensive measure of financial stress is published by the Federal Reserve Bank of St. Louis, which we show in Exhibit 5.

**Exhibit 5: Stressing the Point That There's no Stress**

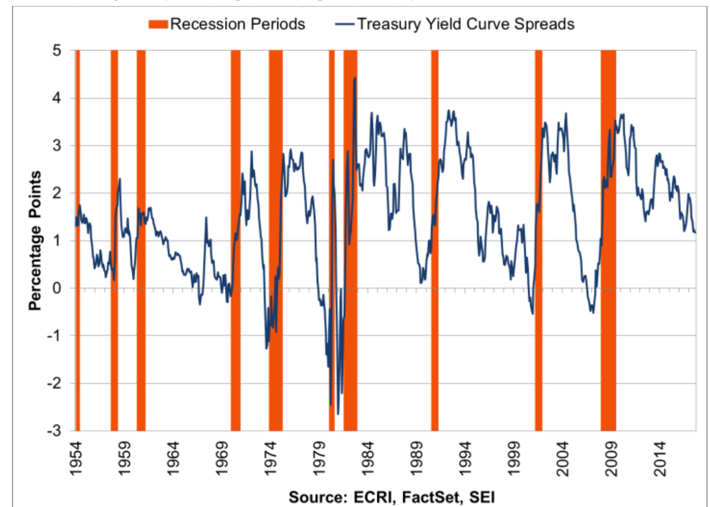


Source: ECRI, Federal Reserve Bank of St. Louis, SEI

It has 18 components, including the absolute levels of short- and long-term interest rates (both government and corporates); various interest-rate spreads (a measure of the yield curve); stock- and bond-market volatility; and the equity performance of financial stocks, among others. The average value of the St. Louis Fed Financial Stress Index is designed to be zero. At this point, financial stress is well below average. In fact, it is near its previous historical lows, first recorded in April 2013 and again in mid-2014. While one can't rule out a pop higher from these extremely low levels, it will take a major event to bring the Stress Index back to an average level, much less to a point consistent with high financial stress and recession.

Unfortunately, the St. Louis Fed Financial Stress Index extends back to just 1994. But one of its components, the Treasury yield curve, has a much longer record. Exhibit 6 shows the spread between long- and short-term Treasury yields since 1954. Note that *every* US recession since 1957 was preceded by a yield curve that turned flat (indicating a small positive difference between long and short rates) or inverted (when short-term rates rise above long-term Treasury yields). There have been times when the yield curve flashed a "false positive." For example, it inverted in 1966 and flattened in 1998 to within 25 basis points of the zero line without a recession developing. But every single recession in the past 60 years was signalled ahead of time by a flat or negative term structure.

**Exhibit 6: As the Curve Swerves**



Source: ECRI, FactSet, SEI

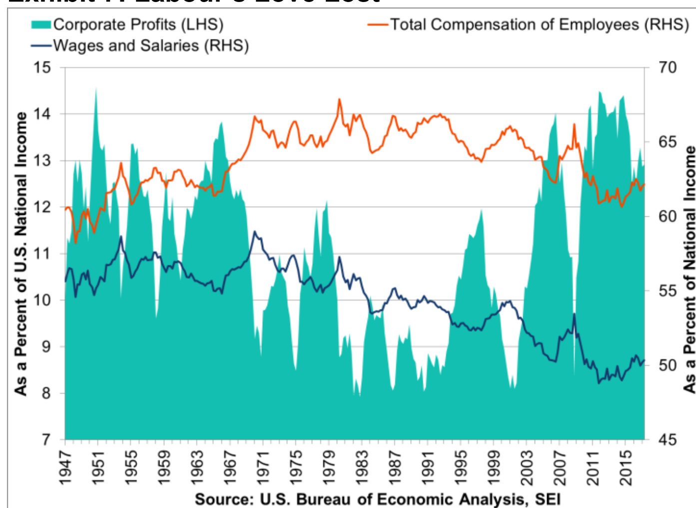
The yield curve widened to 3.6 percentage points in 2010, but has narrowed over time—mainly because bond yields have trended lower while short-term rates have been stuck near zero. More recently, short-term rates have started rising, reflecting the four increases in the federal funds rate since December 2015. Meanwhile, bond yields have meandered around the 2.25% mark. The result has been a narrowing of the spread to about 1.2 percentage points (120 basis points) as of 30 September, 2017. History would suggest that the yield curve is not yet tight enough to indicate an imminent recession.

Recent economic data also point to the continuation of slow-but-steady US economic growth. The recent Atlantic hurricanes will muddy the statistical waters a bit—gasoline prices at the pump increased nationwide immediately after Harvey hit Texas, for example. Unemployment claims also

have been jumping around in recent weeks. That being noted, the negative economic impact of natural disasters tends to be transitory; growth tends to follow within months, as damaged vehicles are replaced and homes and infrastructure are rebuilt or repaired. It is possible, for example, that hurricane-related rebuilding will act as a catalyst to push the unemployment rate below the 4% mark next year and draw more people into the full-time workforce.

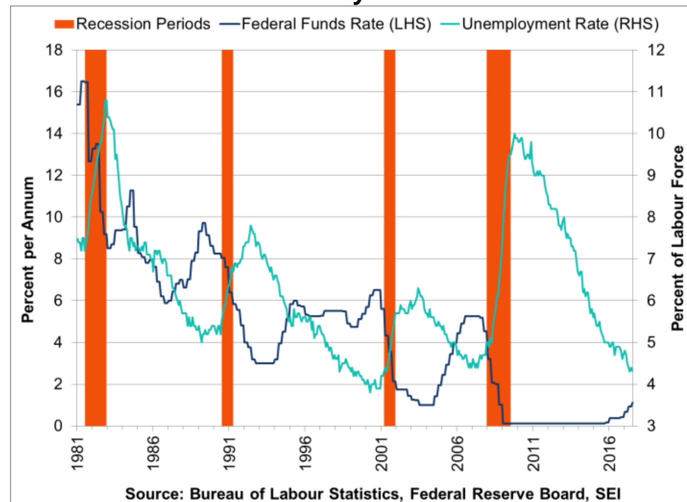
One of the most puzzling aspects of this expansion has been the lack of wage pressure despite the seemingly tight labour markets across many areas of the country. The share of national income accruing to labour has increased modestly in recent years (labour and capital are the primary components of national income). However, the wage and salary component remains extremely depressed (as the solid blue line in Exhibit 7 attests). Total labour compensation has held up better (mainly reflecting the inexorable increase in employer-supported medical benefits); but even this statistic is near its lowest levels since before the mid-1960s. On the flip side, corporate profit margins remain high and have shown little tendency to revert toward the mean.

**Exhibit 7: Labour's Love Lost**




The Fed tends to tighten monetary policy as the unemployment rate gets down to historically low levels (Exhibit 8). The central bank finally started to increase the federal funds rate in December 2015, pushing it even higher and at a faster pace since December of last year. Looking at the chart, it would seem reasonable to conclude that the Fed will methodically push its funds rate up in the year ahead, perhaps to 2% or more before the end of 2018, as anticipated by the Federal Open Market Committee. That's not what traders think, however. Futures markets indicate an expectation of just one or two more rate increases. A truncated tightening cycle would not be unprecedented in and of itself. But it would be highly unusual at a time when the economy is in its eighth year of expansion and the unemployment rate is notably low. Even if the central bank surprises the futures traders and stays on its current track, a federal funds rate approaching 2% doesn't strike us as the end of the world if the US and global economies remain in a synchronised up-trend.

**Exhibit 8: Is the Fed Already at Intermission?**




SEI's overall positioning in US large- and small-cap equities is defensive, partially owing to a high cash position that's geared to take advantage of a long-overdue correction. Our strategies also emphasise holdings oriented to stability and quality. In aggregate, they are overweight the healthcare and financial sectors, and underweight technology (where valuation is judged to be excessively high).

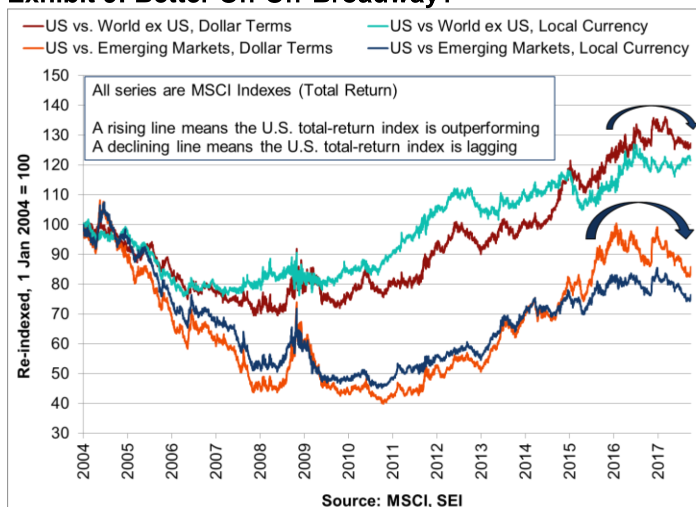
Our US fixed-income strategies are positioned for a continuation of the economic expansion and the beginning of the Fed's balance-sheet contraction. They have been cutting overall risk exposure, yet recently added to their holdings of agency mortgaged-backed securities following a widening of the yield spread in that part of the market. Core fixed-income strategies continue to favour credit-related assets, particularly financials. As interest rates rise, banks should benefit from improving margins; they are much better capitalised than before the global financial crisis and are less exposed to event risk. In terms of quality, our core fixed-income strategies favour BBB rated securities and are underweight the highest-rated AAA paper. They are also positioned for a further flattening of the yield curve, underweighting the two-year Treasury note and overweighting long-term (30-year) bonds.
In the high-yield area, our strategies reduced some positions following strong year-to-date performances. They remain overweight lower-rated debt and collateralised loan obligation equity, owing to the benign credit-default environment. They favour CCC rated debt—especially in the healthcare sector—versus higher-quality BB credits, believing that CCC rated debt tends to be mispriced by investors. Technology and electronics company debt is

overweighted, while basic industry, energy and capital goods are underweighted.

**Time to Take the Show 'Round the World**

The US stock market has been a stellar performer since the end of the Great Recession in mid-2009, whether measured against developed or emerging equities, or in local-currency versus US dollar terms (Exhibit 9).

**Exhibit 9: Better Off Off-Broadway?**



Source: MSCI, SEI

Although the US was the epicentre of the financial crisis, its economy was among the first to recover. It also managed to repair its damaged banking system far more quickly than those of other countries. The eurozone, by contrast, went through a peripheral debt crisis that forced extreme austerity on its weakest members. Japan also could not escape deflation or the effects of demographic decline despite Prime Minister Shinzo Abe's "Three Arrows" program of monetary easing, fiscal stimulus, and structural economic reforms. Meanwhile, emerging markets endured a vicious bear market of their own, owing to the slow-growing global economy and an excess supply of commodities that pushed down the price of energy and other raw commodities. Recessionary conditions prevailed in countries as geographically diverse as Brazil, Russia and South Africa. China's growth also slowed significantly as it tried to rein in excessive property speculation, its shadow banking system, and a debt bubble of historic magnitude.

The US stock market's incredible run against the rest of the world, however, began to peter out versus emerging markets in January 2016—first in US dollar terms and later when measured in local currency. The January peak in US relative performance coincided with the bottoming-out of energy and other commodity prices. The relative-strength peak of US equities versus other developed countries came in the middle of 2016 in local-currency terms. This turn ironically occurred at the same time as the UK's referendum to opt out of the European Union (EU). The Brexit vote turned out to be a cathartic market event rather than a catalyst of further declines in European risk assets.

The economies of continental Europe in mid-2016 were continuing to struggle; although there were some green shoots sprouting, as we observed at the time. We worried that the Brexit vote would cause irreparable harm to trade relations between the UK and the 27 remaining EU members. We also worried that the "leave" vote would reawaken anti-euro sentiment in Italy and elsewhere in the eurozone. As it turned out, aggressive monetary easing on the part of the European Central Bank (ECB) overcame this hit to confidence. In addition, there was no immediate change in trade flows, as the pact between the UK and the EU will remain in place until at least March 2019 and will likely be followed by a long transition period.

The relative performance of US equities topped out against other developed markets more decisively in US dollar terms than in local-currency terms, as Exhibit 9 illustrates. Indeed, in recent months, the US stock market has actually performed significantly better in local-currency terms than on a common-currency basis. We do not expect this divergence to last. If the MSCI USA Index (Total Return) consistently underperforms the MSCI World ex-USA Index (Total Return)—as was the case prior to the global financial crisis—the US dollar should weaken too.

As we said above, the world is in a synchronised economic upswing for the first time in more than five years. Exhibit 10 looks at the year-over-year point change in the Organization for Economic Cooperation and Development's (OECD) index of leading economic indicators, which covers all the OECD member countries as well as larger non-member countries (Brazil, China, India, Indonesia, Russia and South Africa). The index bottomed out most recently in September 2015, and continues to show upward momentum. The data suggest that a large portion of the world is growing at a slightly better-than-trend pace. The breadth of the improvement is particularly impressive; as of July 2017, 72% of the countries that make up the aggregate index posted improvement over the past year—and 75% of the countries in the index came in above 100. This means above-trend growth will likely continue in the months ahead on a global basis.

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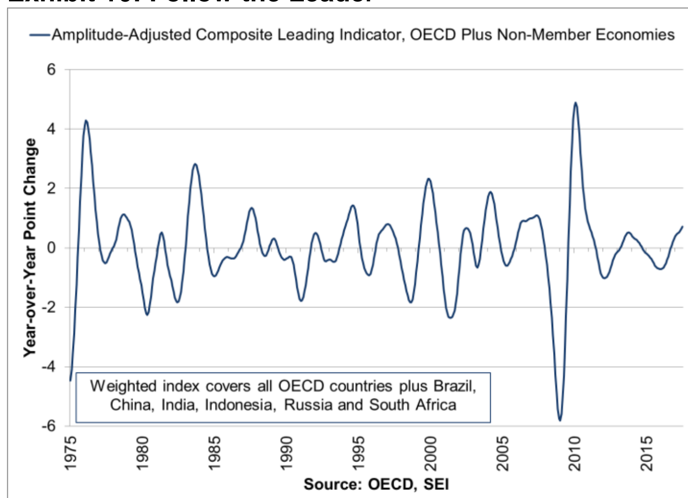
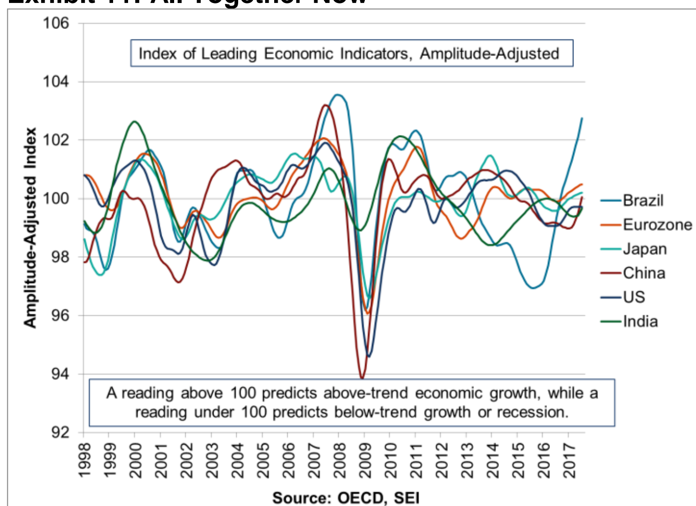
**Exhibit 10: Follow the Leader**



Source: OECD, SEI

Drilling down to the country and regional level (Exhibit 11), the OECD calculated that Brazil's economic situation is improving at the fastest rate despite ongoing political turmoil. The eurozone as a whole looks set to grow above trend, as does Japan. China's momentum remains toward the upside, even though its recent economic data suggest some deceleration. The US economy, by contrast, is growing somewhat below trend; the level of its amplitude-adjusted index (which the OECD derives by adjusting its index of leading indicators to ensure that it agrees with that of its de-trended reference series) hasn't shown much improvement in recent months. India also is signalling below-trend growth, but the absolute level of its index has begun to rebound. On balance, things are looking up in much of the world.

**Exhibit 11: All Together Now**



Source: OECD, SEI

Our international strategies are generally pro-cyclical in their positioning. In Europe, there is a bias toward value-oriented cyclical sectors, such as industrials and consumer discretionary. More stable sectors, such as consumer staples and healthcare, tend to be underweighted due to their valuations. Our strategies are also increasing their exposure to companies that enjoy earnings and price momentum since these areas have become less crowded.

Strategies investing in Europe, Australasia and the Far East also display pro-growth positioning, with overweights in technology and energy as well as off-benchmark exposures to emerging markets and North America. They are underweight consumer staples and interest-rate-sensitive areas (banks, utilities and real estate). In similar fashion, as the Japanese economy shows signs of life, our Japan-based strategies are overweight cyclical stocks and underweight defensives.

SEI's emerging-market strategies have a structural overweight to frontier markets, including Vietnam, Bangladesh and Sri Lanka. They also favour Turkey, based on the country's stimulative fiscal and monetary policies. Country underweights include Brazil, Mexico and South Africa, in addition to the more-persistent underweights to China, Korea and Taiwan. Sector overweights include industrials, consumer staples and healthcare, while underweighted positions include the Chinese financial sector and large technology companies in Korea.

In international fixed income, SEI's strategies are generally positioned in a pro-cyclical fashion. They are short duration[1] versus their benchmarks in Europe and Japan, where yields are low and bond prices appear to have little potential for appreciation; however, they tend to be long duration in markets with higher inflation-adjusted government-bond yields, including Australia, Canada and Mexico. They also favour positions in the corporate credit and securitised sectors that exhibit higher yields and lower duration; although credit spreads are not expected to narrow much further. The strategies are underweight core Europe, are reducing exposure to European peripheral debt, and are overweight the local-currency bonds of emerging markets. Among US investments, they favour Treasury inflation-protected securities.

Our emerging-market strategies are overweight local-currency government debt, especially Argentina and Mexico; less-than-benchmark positions include the Philippines, Romania and China. They favour local-

[1]Duration is a measure of a security's price sensitivity to changes in interest rates. Specifically, duration measures the potential change in value of a bond that would result from a 1% change in interest rates. The shorter the duration of a bond, the less its price will potentially change as interest rates go up or down; conversely, the longer the duration of a bond, the more its price will potentially change.

currency sovereign and corporate bonds as well as BB rated securities, and are underweight lower-quality B and CCC rated credits.

**Dollar Distress**

One of the big surprises of 2017 has been the extensive weakness of the US dollar against most other currencies. The nominal trade-weighted dollar has fallen by about 8% since the end of last year. Exhibit 12 clearly shows that the US dollar can appreciate and depreciate in long cycles, measured in years rather than months. If the peak at the end of 2016 proves to be the top of the current cycle, the most recent upswing would be shorter in duration than previously experienced—but the magnitude of the trough-to-peak rise would be similar to that of the up-cycle that occurred from April 1995 to March 2002 (about 41%).

**Exhibit 12: The Money Song**

Source: Federal Reserve Board, SEI

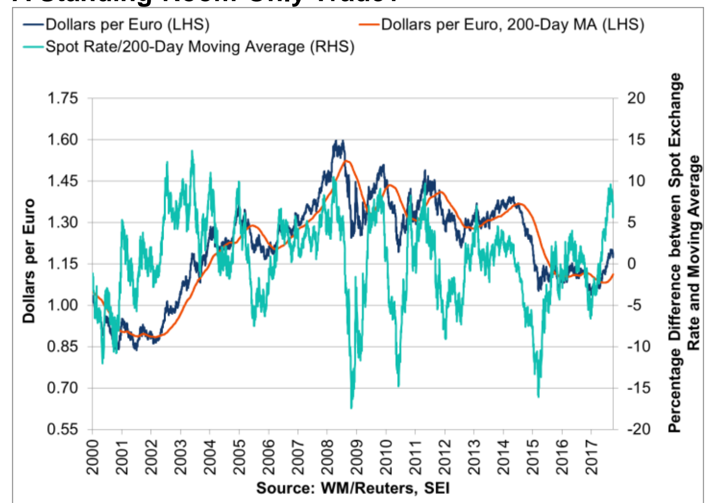
The drop in the greenback coincides with the better global macroeconomic outlook. As we noted above, the economic growth of developed economies around the world is converging with that of the US. Although US monetary policy is further along the path toward tightening, other central banks have already begun to raise policy rates (Canada) or may do so soon (UK). Even the ECB is expected to announce its first steps away from unconventional monetary stimulus by the end of this year.

Political considerations are coming into play as well. Participants in the currency markets have adopted a far more sanguine view regarding the political stability of the eurozone following a series of national elections this year that enhanced the position of the parties favouring further European integration. Even the 5-Star movement in Italy has backtracked from its commitment to dump the euro at the first opportunity—undoubtedly taking a lesson from the poor showing of Marine Le Pen and the National Front in the French presidential and National Assembly elections.

While confidence in the euro and the eurozone economy has increased, international confidence in the US has ebbed. The Trump administration's decision to pull out of the Trans-Pacific Partnership and the Paris climate accord was controversial in the US; it was especially confounding to foreigners, and raised concerns (warranted or not) that the US is relinquishing its role as leader of the free world. Confidence in the existing international economic order was also hurt by the threat of additional trade discord with Canada, Mexico, South Korea and China. In any event, the Trump administration has made it perfectly clear that it does not subscribe to former Treasury Secretary Robert Rubin's notion that a strong US dollar is in the nation's interest.

Although we suspect the US dollar is beginning a transition from secular strength to secular weakness, we're not surprised that the greenback has popped higher in recent weeks. Exhibit 13 conveys the dollar's performance against the euro and compares its current spot value against its 200-day moving average. The chart strongly suggests that the greenback has moved up too far, too fast. At the end of August, the exchange rate reached $1.20 per euro. This move pushed the currency unit's percentage deviation from its 200-day moving average to nearly 10%. This particular statistic has a history of mean reversion. The 200-day moving average was $1.11 at the end of September and should continue to rise. Given the fact that shorting the US dollar has become a "crowded" trade, we think a move in the exchange rate toward $1.15 or lower is a distinct possibility in the months immediately ahead.

**Exhibit 13: Shorting the US Dollar: A Standing-Room-Only Trade?**



Source: WM/Reuters, SEI

In terms of currency positioning, SEI's strategies with notable currency positions have reduced its exposures to the US dollar, switching from a net-long position to a net-short versus the euro, Japanese yen and Chinese renminbi. Those strategies also have the US dollar short against the British pound, but long against the Australian

dollar. Currency overweights also include the Mexican peso, Brazilian real, Colombian peso and Chilean peso, reflecting the activity of our fixed-income emerging-market strategies.

**Some Things in Life Are Bad**

In this report, we have looked on the bright side of life, explaining why we're relatively upbeat on the global economy and, by extension, risk assets. We would be remiss, however, if we didn't "chew on life's gristle" a little bit. Here are some of the potential problems we are keeping an eye on:

*US tax cuts and reform efforts collapse*

We continue to believe that a business-friendly tax package will be enacted and signed by Trump before the end of the year. If the discussions carry over into calendar-year 2018, we think congressional leaders will pledge to make any tax changes retroactive to the beginning of the New Year. We have been looking for a cut in the statutory corporate tax rate from the current 35% to a new top rate of 25% or less. A repatriation holiday also will be part of that package, resulting in a significant inflow of cash held abroad. Those repatriated funds can be used for capital investments, debt pay-downs, dividends and stock buybacks. Tax cuts for households are likely to be more limited; the extent of changes made to income-tax rates will depend on the success of negotiators to eliminate or cap the benefits accrued primarily by high-income earners, such as deductions for state and local income and property taxes.

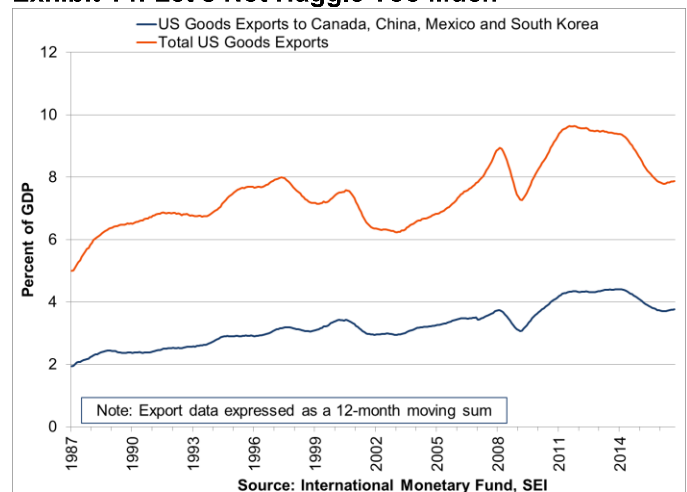
Considering the poor legislative track record of efforts made to repeal and replace the Affordable Care Act, we think our optimism on tax changes is out of consensus. The Russell 1000 Value Index, a terrific relative performer in the months immediately following the election of Trump, went nowhere between early March and early September; by contrast, the Russell 1000 Growth Index made a series of new highs, primarily driven by the technology sector. In the year-to-date, the growth Index advanced 21% on a total-return basis, while the value Index posted an 8% gain. In the absence of tax legislation, investors' expectations for US economic growth could be further dampened, hurting economically sensitive value stocks. It could also cause a serious correction in the overall stock market, something that has not happened in more than a year. SEI's strategies are generally positioned to benefit from a rebound in value and smaller-cap stocks.

*A Trumpian trade war*

Trump was voted into office partially owing to his populist stance on trade. It has certainly resonated in areas of the country that have endured sharp declines in high-paying manufacturing jobs, as companies developed global supply chains and pushed manufacturing capacity abroad. Thus far, only the Trans-Pacific Partnership deal has been halted by Trump's "America First" policy approach on trade. While negotiations aimed at "modernising" the North America Free-Trade Agreement have begun, it is unclear where they will go. Trump has aimed critical tweets at the trade deal negotiated with South Korea—a particularly ill-timed initiative given the tensions regarding North Korea's nuclear-missile capabilities. China, of course, is in the Trump administration's crosshairs over a number of trade issues too, including steel and intellectual property. There's also the added tension vis-a-vis China as the US administration attempts to squeeze North Korea for ignoring the United Nation's anti-proliferation resolutions.

Although the US runs trade deficits with these countries, its exports to them have been growing at a faster pace than the overall US economy. Exhibit 14 shows US exports as a percent of nominal gross-domestic product (GDP). Total exports have trended higher over the past 30 years and now account for about 8% of US GDP, up from 5%. Meanwhile, the total share of exports to Canada, China (including Hong Kong and Macao), Mexico and South Korea has doubled, from 2% in 1987 to about 4% of GDP as of 30 September, 2017. These countries now account for half of America's exports of merchandise. Clearly a trade war would be in no one's interest. In the 1930s, the US Smoot-Hawley Act imposed high tariffs on imports that led to a tit-for-tat trade war and a downward spiralling of global economic activity. US agriculture, mining and manufacturing were decimated. We think such a trade war could be as dangerous an economic blunder today as it was during the Great Depression.

**Exhibit 14: Let's Not Haggle Too Much**

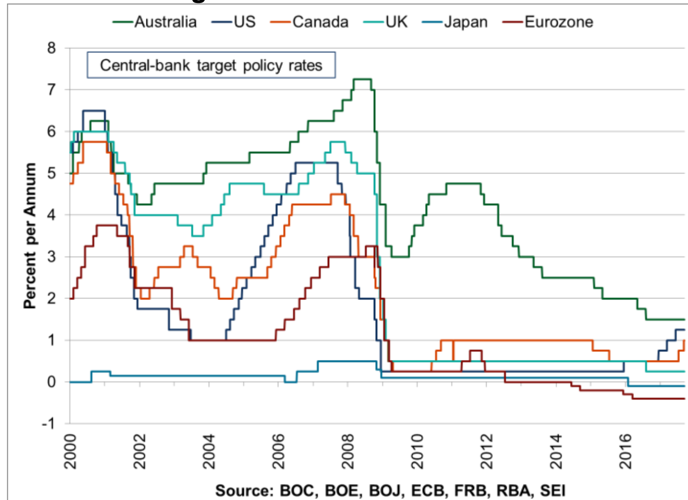



*A monetary policy mistake*

As noted above, the upturn in global economic activity is spurring the world's major central banks to reassess their policy stance. The US Fed is slowly normalising rates and will begin to allow its balance sheet to contract as securities mature. The ECB appears on the cusp of taking its first steps away from large-scale asset purchases and

negative interest rates. The Bank of England (BOE) has put the global markets on notice that it is prepared to increase its bank rate soon. The Bank of Canada has pushed through two interest-rate increases in quick succession (Exhibit 15).

**Exhibit 15: Target Practice**



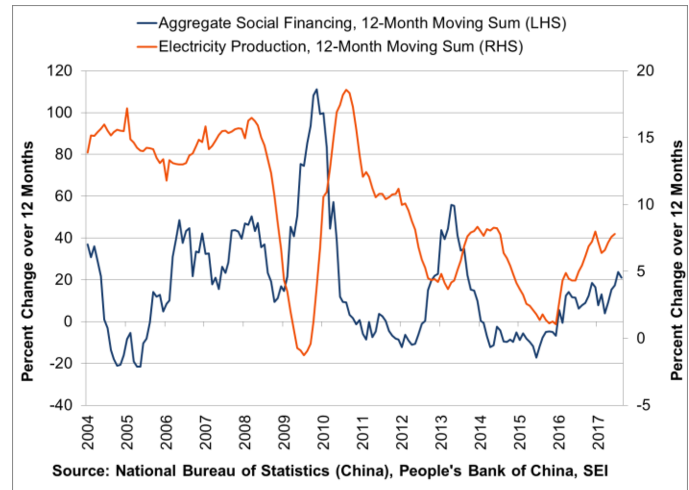

The danger is that central banks could make a policy mistake, either by acting too quickly or not quickly enough. The US Fed, for example, seems to be gearing up for further tightening moves. Yet the consensus view forecasts a slow Fed response on the grounds that inflation pressures will remain muted. Our concern would be that the Fed and investors are surprised by a flaring up of inflation, necessitating a more aggressive policy move by the monetary authorities. In Europe, by contrast, the concern would be a normalisation of policy that may turn out to be premature. The strength of the recovery could prove more fragile than expected. In addition, the ECB continues to miss its 2% inflation target, with the most recent year-over-year gain in eurozone consumer prices measuring just 1.2%.

The central bank with the greatest policy challenge is the BOE. It faces an accelerating inflation rate at a time when overall economic growth has been somewhat below that of the US and eurozone. Although the BOE has signalled its intention to reverse the easing implemented in the aftermath of the Brexit vote, it is unclear whether the correct policy course calls for further tightening moves.

*China steps on the brakes*

We have remarked in the past about China's stop-and-go economic monetary and fiscal policy decisions. In the run-up to this October's all-important National Congress of the Communist Party of China, economic policy has been geared toward growth. Exhibit 16 shows that total social financing, a broad aggregate of credit growth, has reaccelerated to more than 20% on a year-over-year basis. We compare social financing to electricity production, a good coincident indicator of economic growth. Note how the cycle for credit has led the cycle for electricity production by about 6 to 12 months in recent years.

**Exhibit 16: I Like China Ease**




It's no secret that the government of President Xi Jinping has been focused on restraining rampant speculation in the property markets and curtailing the growth of the shadow banking system. This attempt has been met with mixed success. As soon as the economy begins to weaken and financial markets exhibit signs of stress, China's economic planners tend to step off the brake and reengage the accelerator.

It may be time to step on the brake again following the mid-October National Congress and the likely strengthening of President Xi's political power coming out of that meeting. Exhibit 17 shows that the producer price index for manufactured products has escalated rapidly, from a minus 3.5% year-over-year change (deflation) in August 2015 to a peak of 11.6% (inflation) in February 2017.

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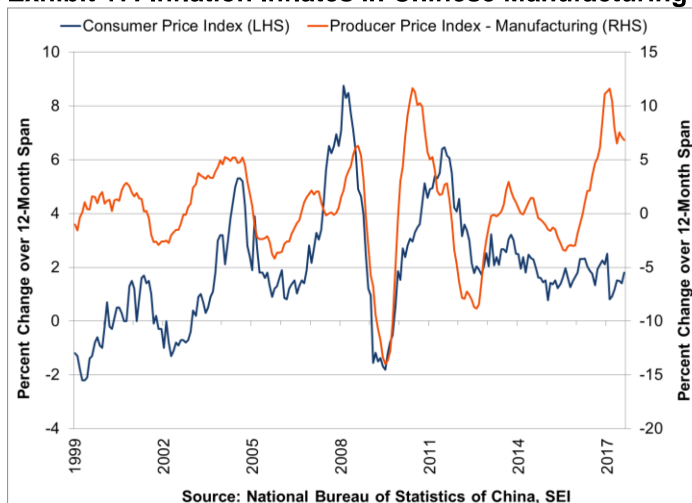
**Exhibit 17: Inflation Inflates in Chinese Manufacturing**




Source: National Bureau of Statistics of China, SEI

Although the current inflation rate for manufacturing producer prices has eased below 7%, it is still around the peak levels recorded in 2004, 2008 and 2011—all periods of sharp deceleration and/or decline in total social financing. A cyclical slowdown in China's economy would likely be bad news for commodity prices and emerging economies. Since the overall consumer price index remains at less than a 2% rate, we're betting that the People's Bank of China will try a gentle tap on the brake.

**Investing on the Bright Side of Life (Reprise)**

Although the bull market in US equities and other risk-oriented assets is elderly, we do not think it is on its last legs. While we would not rule out a correction in asset values more notable than others that occurred in the past 18 months, our investment mantra of "buying on the dip" still holds for investors with spare cash sitting on the sidelines. We need to see more-aggressive tightening by the Fed and other central banks before concluding that a bear market is on the horizon. Such policy changes probably won't materialise until inflation accelerates more convincingly.

Our equity strategies remain positioned for further cyclical improvement around the world. They generally have a smaller-cap and value basis versus their benchmarks. We tend to favour momentum-oriented opportunities, and view equity markets outside the US as more attractive than US equity markets. Indeed, our caution toward equities is most pronounced in the US, where valuations are elevated and the outlook for growth in profits is comparatively modest.

On the fixed-income side, we expect yields will slowly move higher as global growth becomes more entrenched and central banks begin to remove the extraordinary stimulative measures of quantitative easing and zero/negative interest rates. Our strategies are generally short duration versus their benchmarks, favour credit-spread strategies and are positioned for a further narrowing of the yield curve (especially in the US).

Like the play *Spamalot*, we think the bull market in risk assets is a long-running show.

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