Economic Overview
Quarterly Investment Review

Second Quarter 2017

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Point of View

Economic Outlook

The Outlook: Investors Dance to a Song with a Bad Beat

The good news

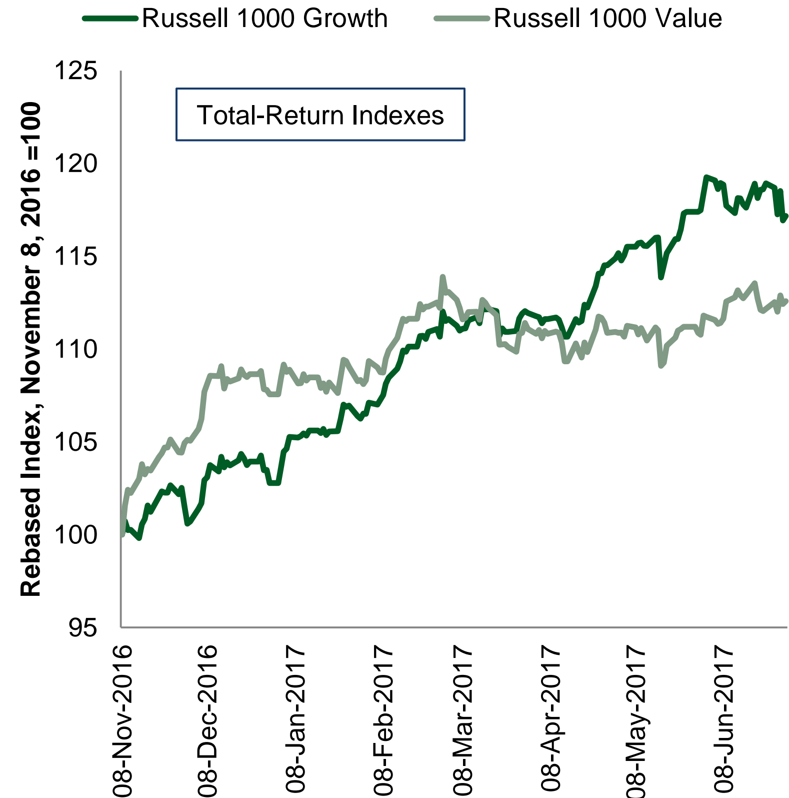
- The global economy continues to improve at a moderate pace.
- Inflation and wage pressures remain relatively subdued, even in the U.S. where the labour market is getting tight.
- We are sticking to our expectation that a major tax bill will be pushed through the Congress this year, enhancing growth prospects for 2018.
- Loan growth in Europe has accelerated to its best pace in six years as Eurozone countries finally address the poor condition of their banking system.
- We see a better outcome for U.K. services companies following the surprising election setback sustained by the Conservative Party.
- Despite strong gains both this year and last, we think emerging markets are still attractive on a valuation basis relative to developed markets.

The bad news

- Central banks have switched to a more hawkish tone as their economies post more durable improvements.
- The U.S. Fed already has started raising interest rates and will likely begin to normalize its balance sheet by September.
- The odds of a stock-price correction in the U.S. have risen as valuations become demanding, although the duration and magnitude of any pullback should be of limited scope.
- Although populist sentiment in Europe has been blunted, it has not been eradicated.
- The sharp increase in debt across developing economies, led by China, remains a nagging worry as a potential source of market instability.
- We are still concerned that trade-war fears will flair up again as President Trump seeks to reduce imbalances with China, Mexico and Germany.

Growth and Value do the Twist

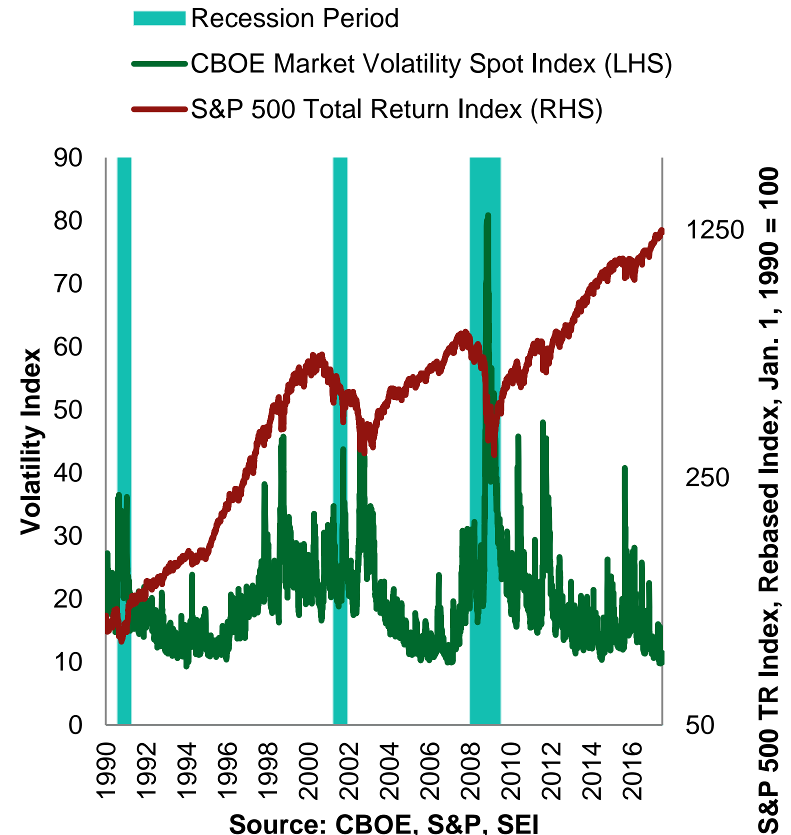
- In the U.S., stock-market sectors that performed well immediately following the presidential election have lagged the overall market in the year to date (financials), while post-election laggards (utilities, consumer staples, real estate, healthcare and, until recently, technology) have bounced sharply 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.
- Throughout these gyrations, the U.S. equity market has managed to climb to new record highs (as measured by the S&P 500 Index).



Source: Frank Russell Company, SEI

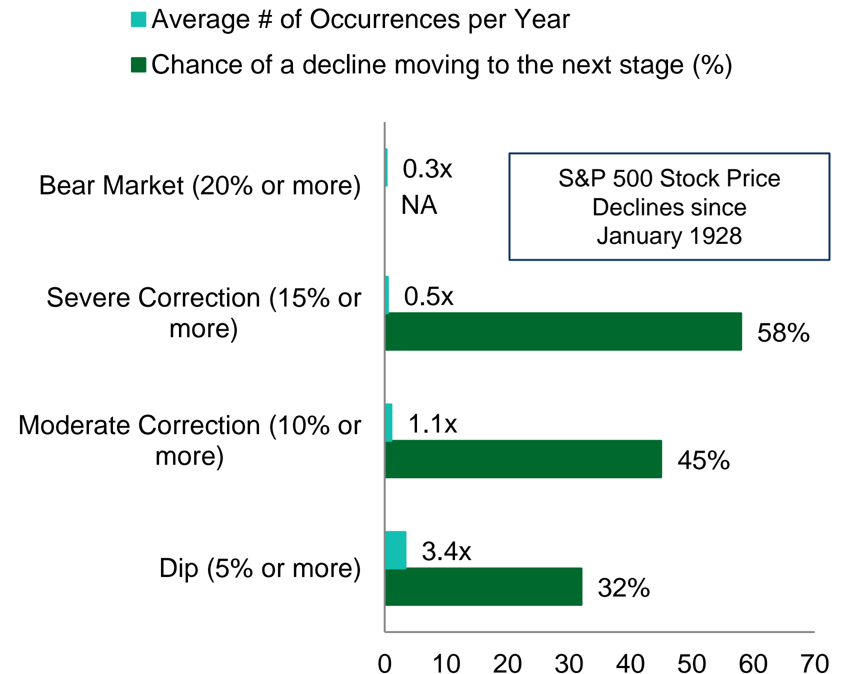
Where's the Volatility?

- The lack of volatility in the overall stock market has brought the widely watched Chicago Board Options Exchange Market Volatility Index (or VIX Index) to extremely low levels.
- 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.
- 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%.



Crying Time

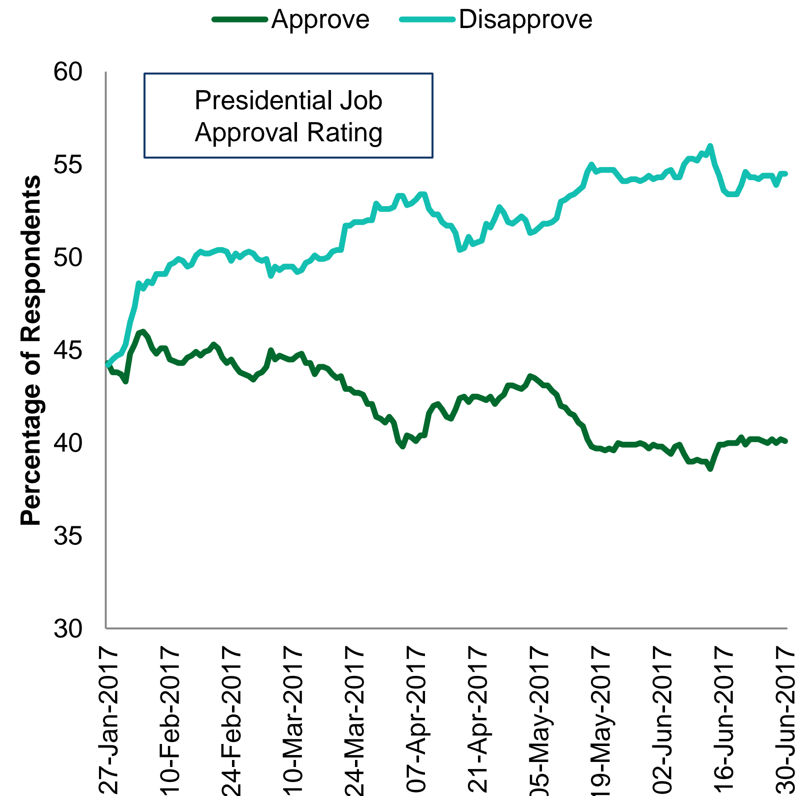
- One can certainly make the argument that this market is overdue for some sort of pullback.
- It's not a question of whether a correction will take place; it's simply a matter of timing and magnitude.
- In our opinion, stresses on the equity market haven't built up to the point where a major correction is likely. Rather, we would expect a more modest pullback, with the timing not at all certain.



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

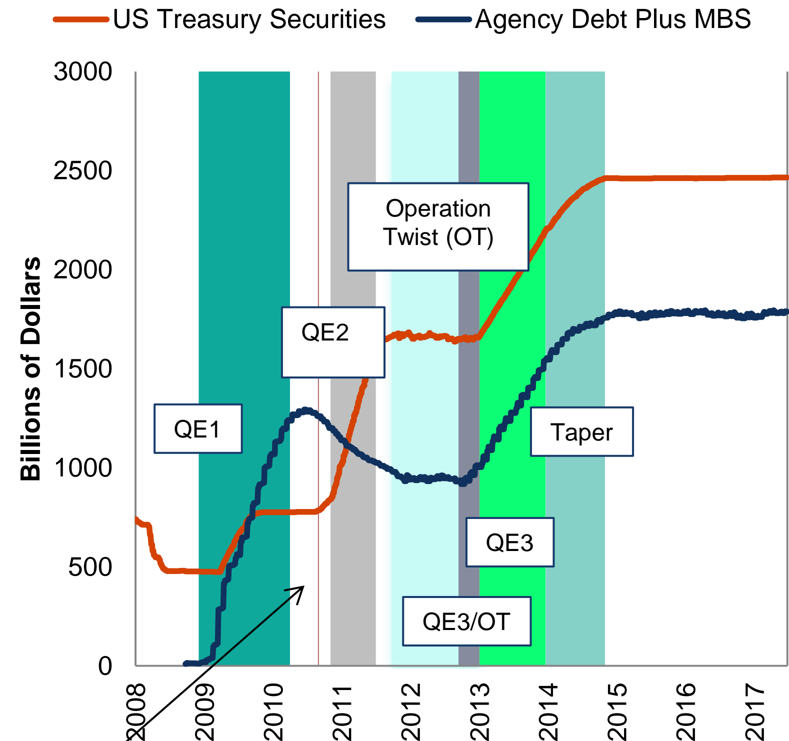
Trump: I Can't Get No Satisfaction

- When he entered office in January, Trump's initial approval and disapproval ratings were historically poor.
- The Republican president's unpopularity has emboldened his opposition to put up a unified resistance against the most impactful legislative items on the Republican agenda.
- 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.
- 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.



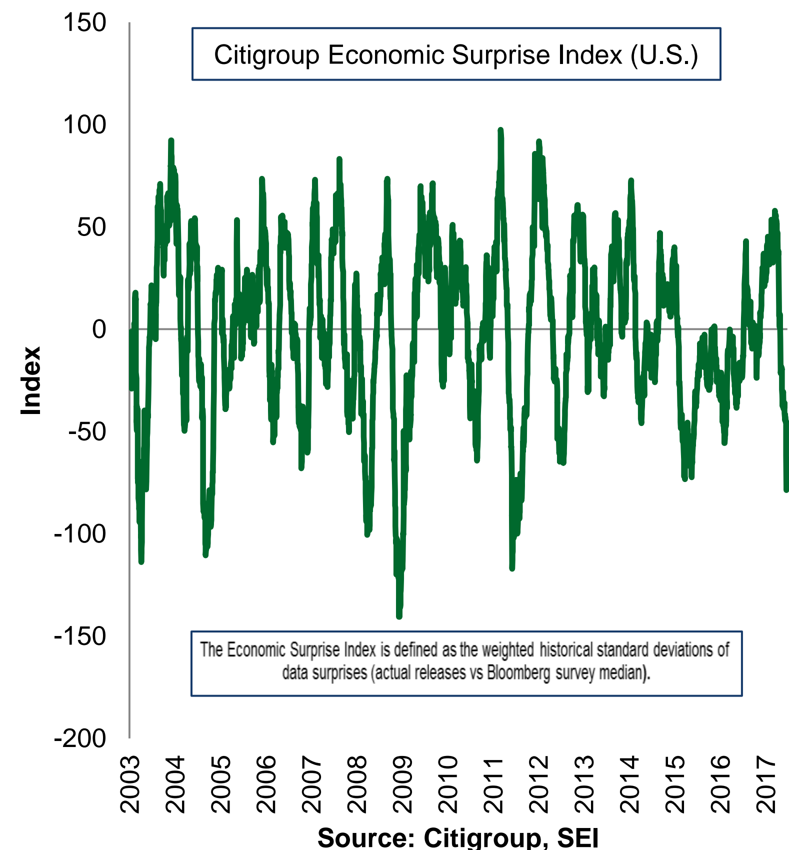
The Fed Sings Let's Twist Again

- The end result of the U.S. 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 on all the major elements needed to offset revenue lost from tax-rate reduction. This should boost the prospects for economic growth, but could eventually add to inflationary pressures.
- We suspect U.S. Federal Reserve Chair Janet Yellen and her colleagues are coming to the same conclusion, based on their decision to raise the federal funds rate twice 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.



Please Help Me, I'm Falling

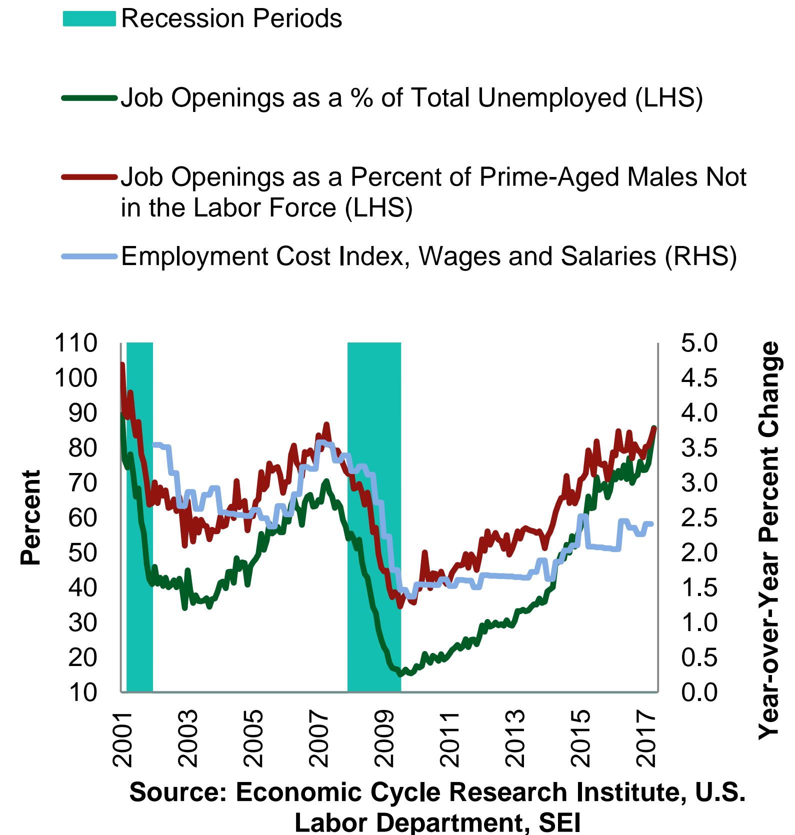
- The other unknown is exactly when the Fed will begin the quantitative tightening program, but it appears that the central bank will begin the process by September.
- We view this as significant since it appears Fed policymakers are looking past the current weaker-than-expected economic numbers.
- The 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 U.S.
- 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 ahead, to a time when tight labour markets start to exert an upward impact on wages and inflation.



Source: Citigroup, SEI

Get a Job

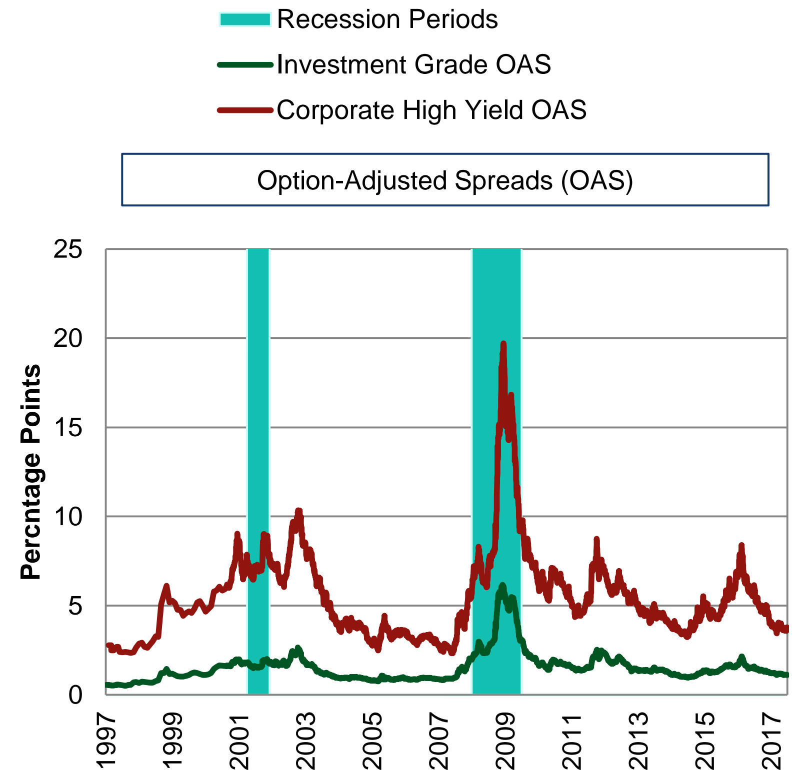
- One of the great puzzles of this cycle is the lack of upward pressure in the U.S. inflation rate despite the tightening labour market.
- According to the U.S. Department of Labor, job openings in the U.S. exceeded six million in April—a new high for this economic cycle.
- Yet wages and salaries, as 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.



Source: Economic Cycle Research Institute, U.S. Labor Department, SEI

Hold Me Tight

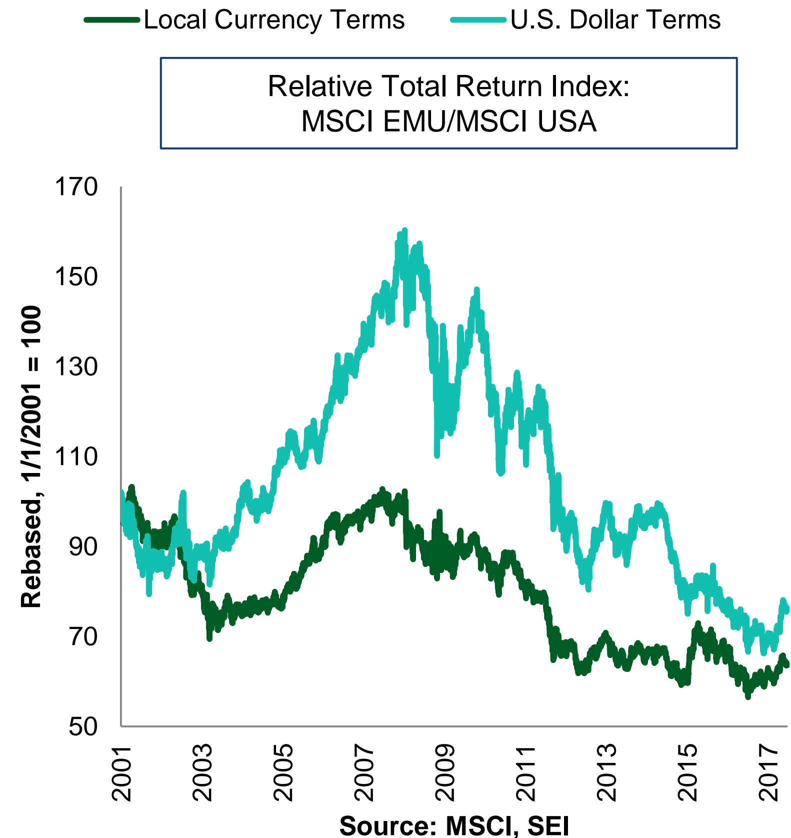
- The connection between tight labour markets and wage inflation has seemingly been severed by stubbornly slow economic growth and little visible progress on tax reform and fiscal policy stimulus.
- We believe this is why investors have returned to strategies emphasizing yield and stability.
- Fixed-income yields are low in absolute terms, and credit spreads are tight relative to Treasury bonds.
- 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, increase the vulnerability of fixed-income assets to a negative surprise.



Source: Bloomberg Barclays, Economic Cycle Research Institute, SEI

U.S. Equity: Kind of a Drag

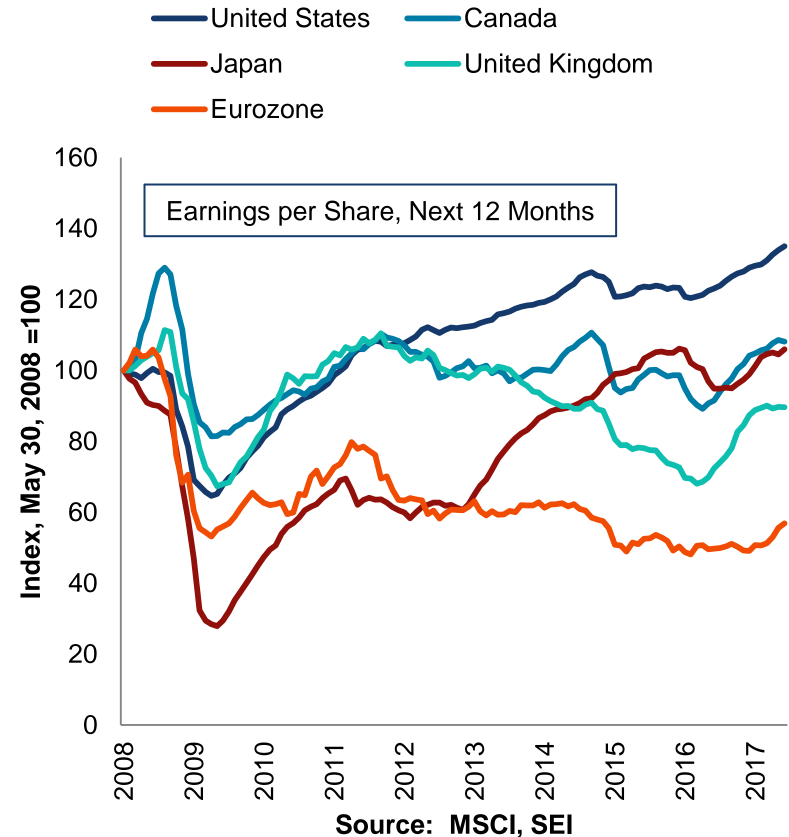
- U.S. equities, have lagged both developed- and emerging-market equity benchmarks in the year to date.
- In fact, the underperformance of U.S. equities versus emerging markets extends as far back as January 2016, when measured in U.S dollars.
- Perhaps the current bout of underperformance against the rest of the world will prove transitory. But we no longer view U.S. equities as the best game in town.



MSCI EMU = MSCI European Economic and Monetary Union Index

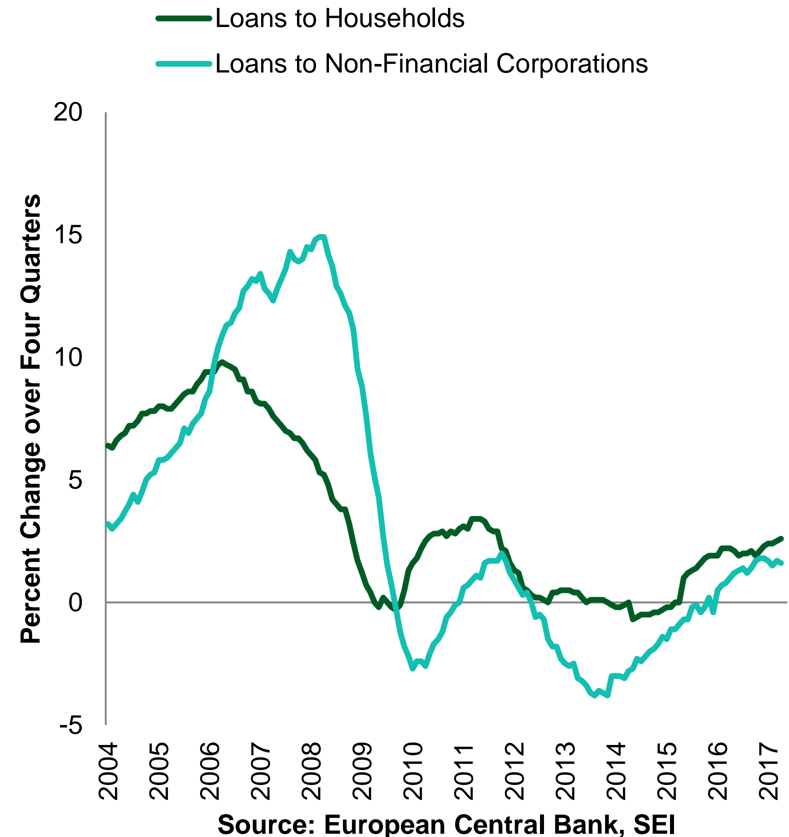
European EPS: Oh Happy Day

- 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.
- Most importantly for investors, eurozone earnings have finally begun to pick up.
- 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.
- But the profits recovery seems to have strong momentum behind it.



More Money for You and Me

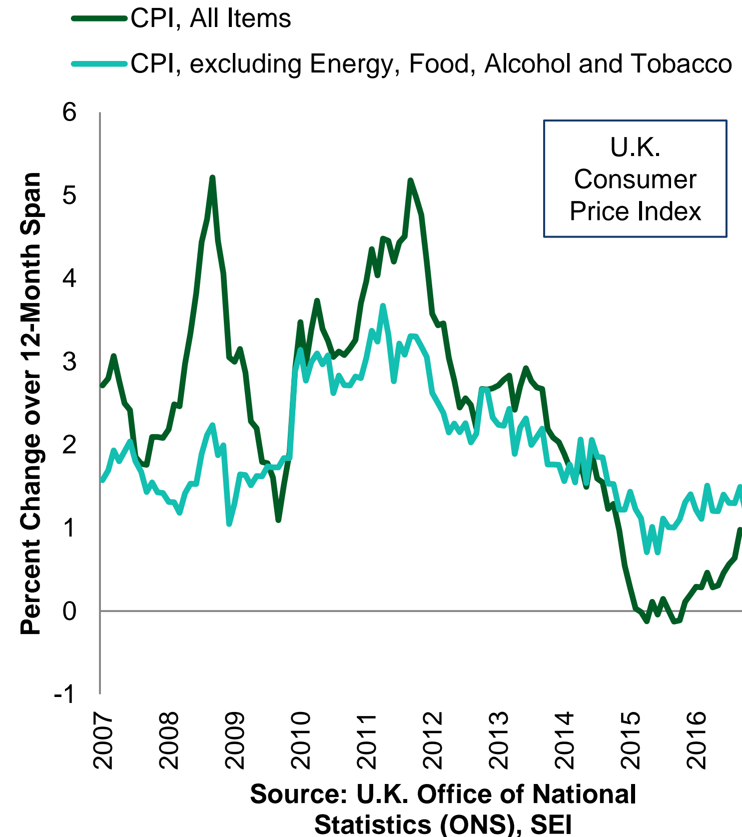
- Loan growth to businesses and households has accelerated to the best pace in six years (albeit still muted compared to the years before the global financial crisis).
- This encouraging-yet-slow expansion in credit argues strongly in favour of ECB President Mario Draghi's long-standing preference to maintain the current pace of quantitative easing at least through the end of the year.
- While we anticipate that the central bank will maintain its negative-interest-rate policy well into 2018, Draghi's rhetoric has recently 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.



Source: European Central Bank, SEI

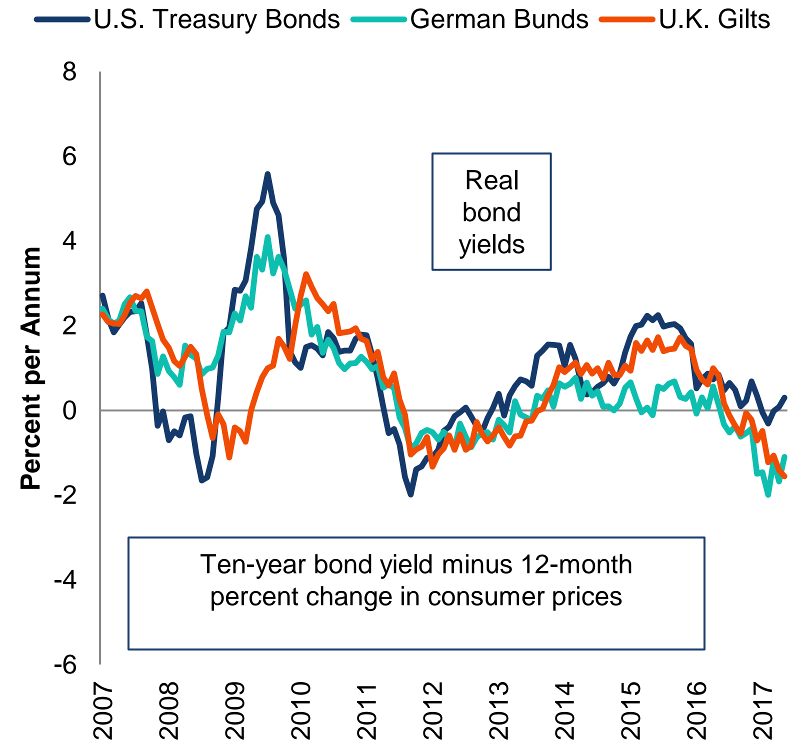
UK Inflation: Bad Moon Rising

- The latest political surprises in the U.K. come at a time when the U.K. 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%.
- This move upward in the inflation rate reflects, in part, the pass-through costs of imported goods and can be traced directly to sterling's 20% decline since August 2015.
- The rise in inflation has not been matched by rising incomes and might be another reason why the Conservative Party government was given a good, swift kick by the electorate.



Ain't Nothing Like the Real Thing

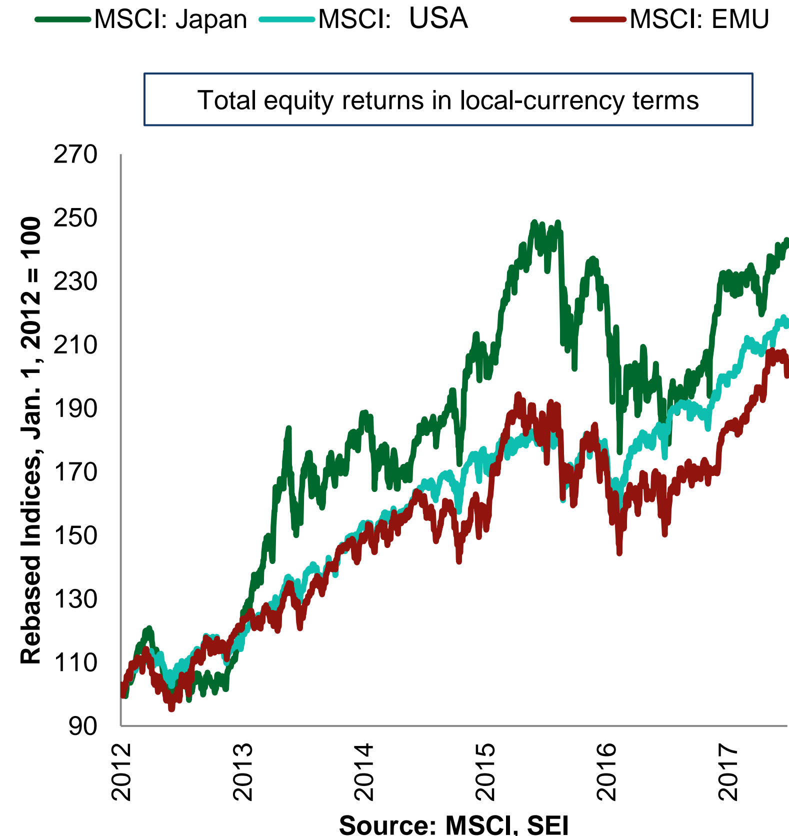
- Three out of eight Monetary Policy Committee members voted in June to raise the base rate by 25 basis points, expressing concern that the BOE is falling behind the inflation curve and that the U.K. economy is now running close to full potential.
- BOE Governor Mark Carney made clear that the majority has little appetite for tightening monetary policy at this time; although, his remarks have since grown more hawkish.
- In the bond market, 10-year U.K. 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 U.S.
- When taking inflation into account, the gilt yield in real terms amounts to a negative 1.55%. Even Germany looks to be a better value at this moment.



Source: Eurostat, U.K Office of National Statistics (ONS), U.S. Labor Department, Tullet Prebon Information, SEI

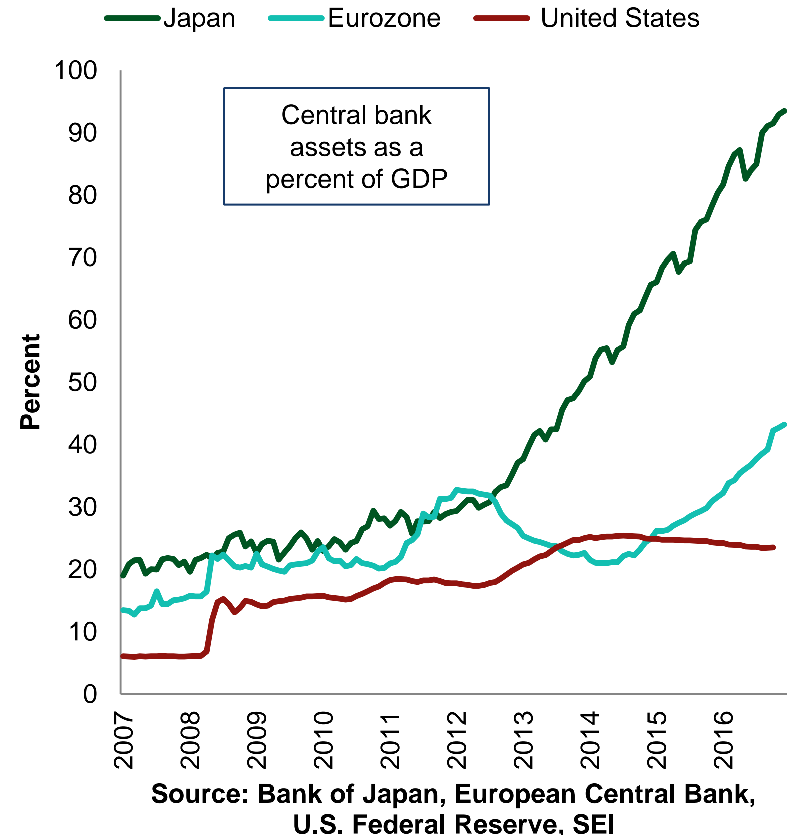
Japanese Equities: Leader of the Pack

- If a trophy were given out for the most underrated stock market, we would give our vote to Japan.
- As implausible as it may sound, Japan's population is projected to decline by more than 30% over the next 40 years.
- This demographic headwind has led to extremely slow inflation-adjusted GDP growth and a prolonged struggle with falling consumer prices.
- Yet Japanese equity prices have outperformed both U.S. and European equities since 2012, when Prime Minister Shinzo Abe entered office. Japan's surprisingly strong stock-market performance reflects investor optimism that Prime Minister Abe's reform efforts will bear fruit over time.



Japan’s QQE: Take a Walk on the Wild Side

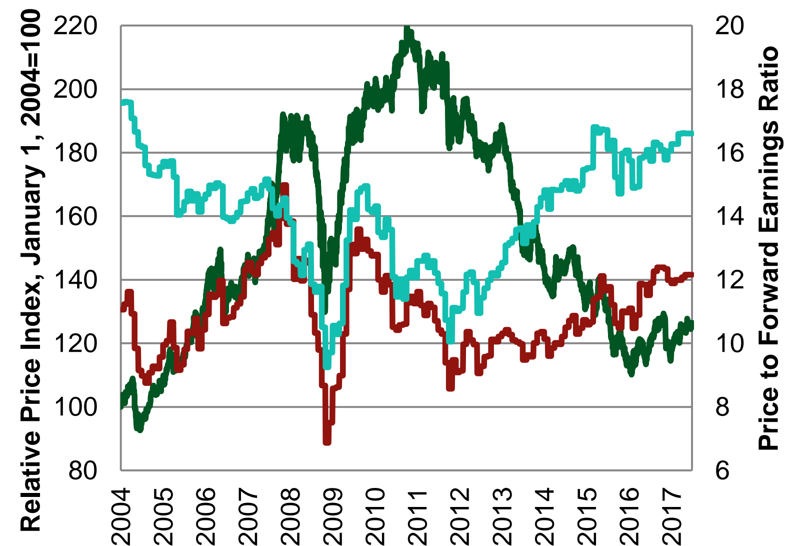
- Another factor behind the strong performance of Japanese equities stems from the liquidity infusion into the economy provided by the Bank of Japan (BOJ) through its quantitative and qualitative easing program.
- As a percentage of GDP, the BOJ’s holdings are almost as large as the economy itself.
- Compared against the yield curve as it existed one year ago, interest rates remain low across the maturity spectrum, especially at the long end.
- With rates in the U.S. moving up and the differential versus Japanese yields widening, we look for the yen to resume its trend of weakening against the U.S. dollar. This should serve as a tailwind for additional price appreciation in Japanese equities.



Source: Bank of Japan, European Central Bank, U.S. Federal Reserve, SEI

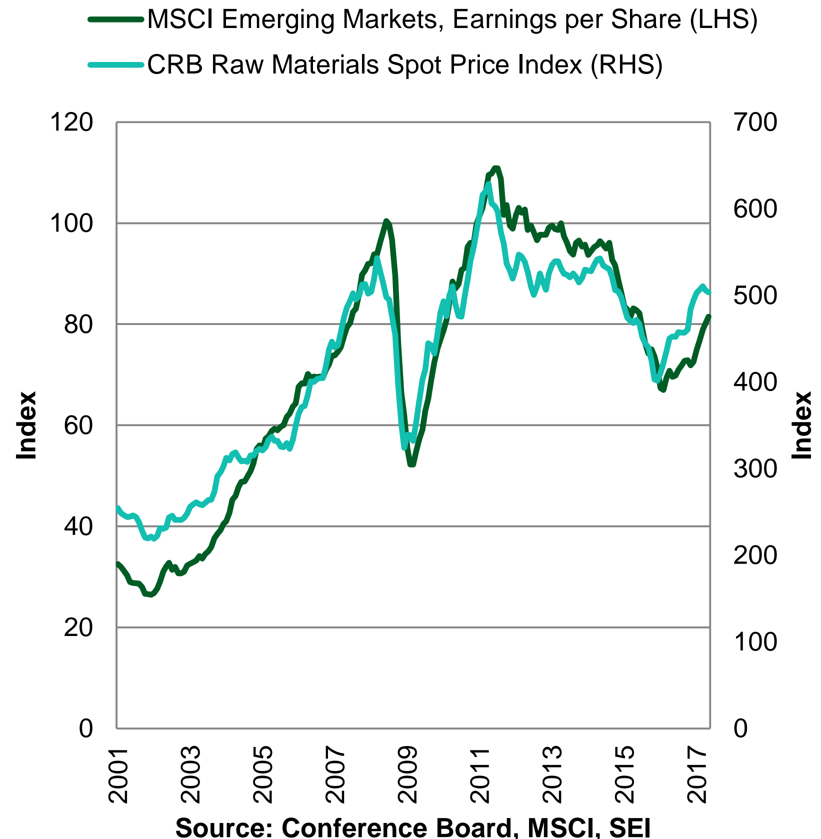
What a Wonderful World

- Developing-market equities have been on a tear this year, with the MSCI Emerging Markets Index climbing almost 19% in U.S. dollar terms in the year to date, and a still-substantial 15% when measured in local-currency terms.
- Despite the gains, emerging-stock markets still look attractive on a valuation basis, but are not the only draw for investors.
- 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.



EM Earnings Coming on Strong

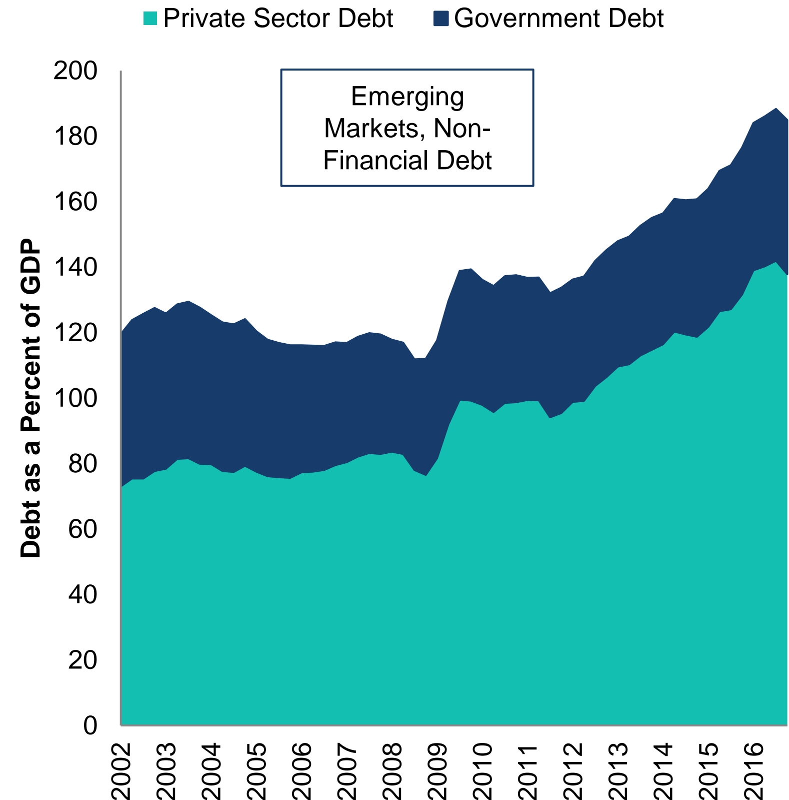
- The global economic upswing and a somewhat weaker U.S. dollar have pushed commodity prices higher.
- The correlation between the Commodity Research Bureau's (CRB) spot price index for raw materials and the earnings trend of developing-market companies has been close over the years.
- At this point, we expect current trends to hold—moderate global economic growth, rising inflation that leads to commodity-price gains, and a stable or slightly weaker U.S. dollar—all of which provide a favourable macroeconomic backdrop for emerging-market economies and financial markets.



Source: Conference Board, MSCI, SEI

EM Debt: The Beat Goes On

- 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%.
- 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.
- Emerging-market bond investors are still upbeat, however. The option-adjusted spread on U.S. 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.



Source: Bank for International Settlements, SEI

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QIR: Important information

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CONTINUED OVERLEAF

QIR: Important information (continued)

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- 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.
- 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.
- Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.
- Narrowly focused investments typically exhibit higher volatility.
- Securities focusing on a single country may be subject to higher volatility.
- Investments in smaller companies typically exhibit higher volatility.

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