Economic Overview
Quarterly Investment Review

Fourth Quarter 2017

SEI New ways. New answers.®

Point of View

Economic Outlook

The Outlook: Dancing Days for the Global Economy and Financial Markets

The good news

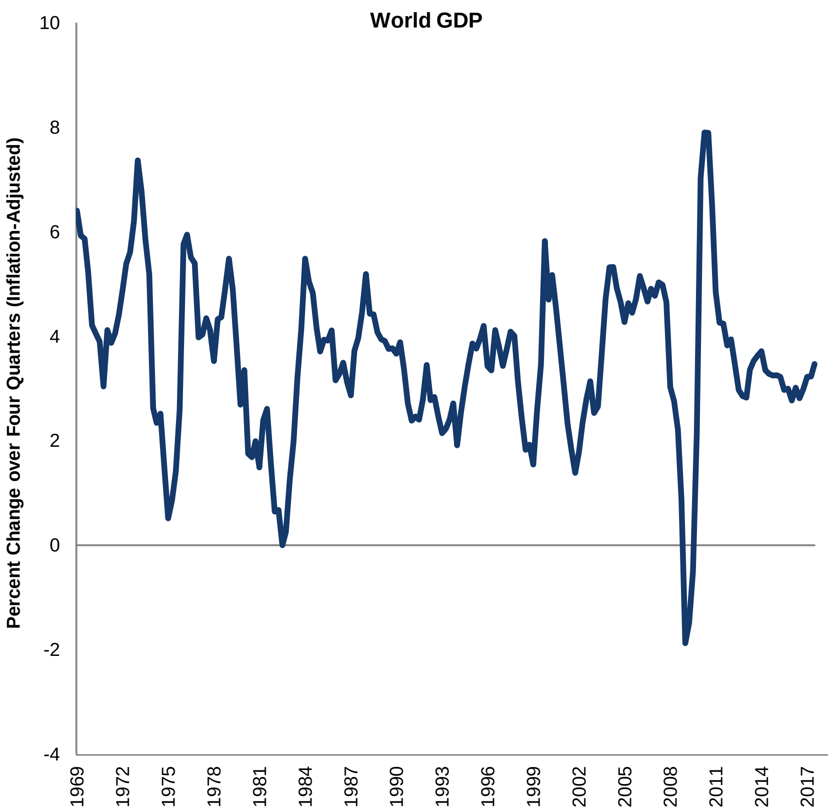
- The global economy is accelerating, with most countries and regions entering 2018 on a strong note.
- Global inflation and wage pressures remain relatively subdued, although labour-related statistics strongly suggest the US is approaching full employment.
- Passage of the US tax bill should provide a modest tailwind to economic growth in 2018 and serve as a catalyst for additional gains in corporate profits and the equity market.
- There are signs that the S dollar is beginning a transition from secular strength to secular weakness, a development consistent with improving relative economic and financial-market prospects outside the US.
- We will continue to give the bull market in equities and other risk assets the benefit of the doubt until we get an aggressive tightening of monetary policy and see the outlines of a looming recession.

The bad news

- SEI is sympathetic to the view that stock prices (especially in the US) now discount much of the good news that is out there. We would not rule out a garden-variety pullback in stock prices and expect low, but positive, returns in US equities in 2018.
- There is a danger that the Fed and other central banks could step up the pace of interest-rates increases beyond those already projected.
- The Trump Administration continues to press major trading partners (Canada, China, Korea, Mexico) for a “better deal.” A tit-for-tat trade war would hurt global growth and add to inflation pressures.
- Geo-political events still have the potential to upset the current upbeat view, even though investors shrugged off such concerns last year. The US-North Korea stand-off, rising tensions between Iran and Saudi Arabia, Brexit uncertainties and elections in Italy, Mexico, Brazil and the US (among others) could spark a return to market volatility.

Good Times, Bad Times

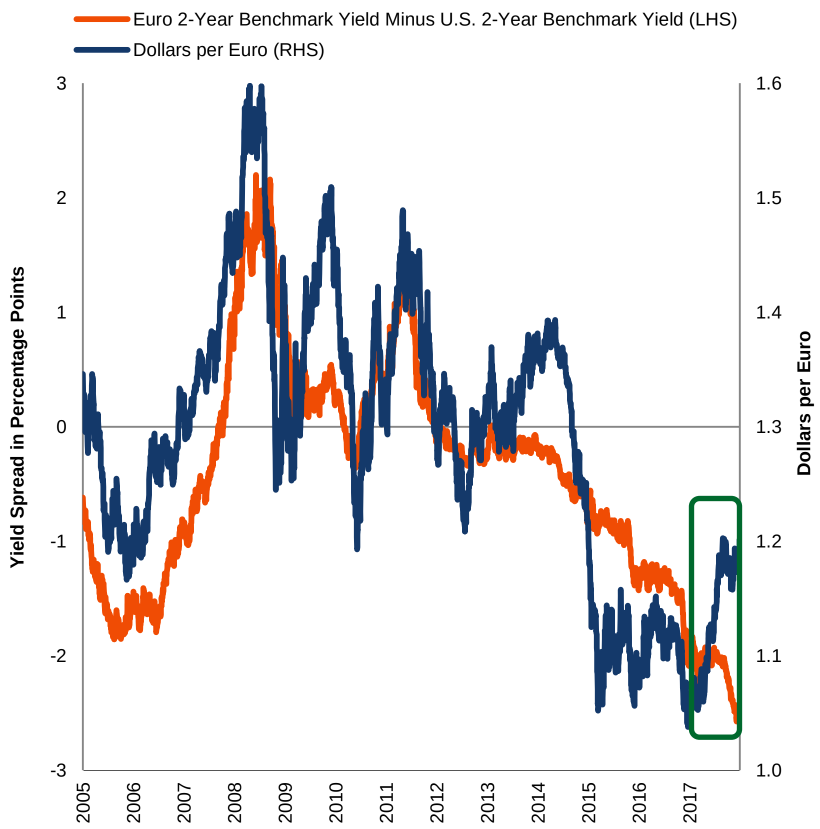
- Growth in world gross domestic product (GDP) ticked higher during the first half of 2017.
- Even the most pessimistic forecasters now concede that the improvement in economic activity continued to build during the second half of 2017, probably resulting in a full-year gain in world GDP of 3.75% in inflation-adjusted terms.
- Yet, this improvement needs to be placed in perspective. Developed economies continue to run at a rather sluggish pace of 2%-to-2.5%. This is, at best, a middling sort of performance in the context of the past five decades.



Source: International Monetary Fund, SEI
As of 30/09/2017

The Euro Surprises to the Upside

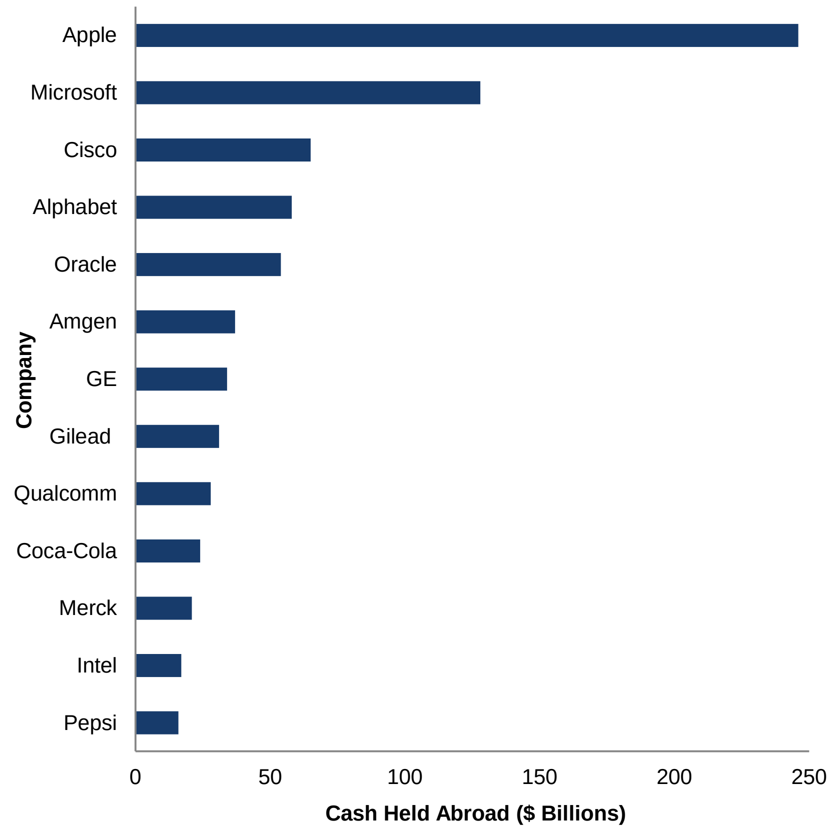
- Coming in to 2017, we did not forecast the notable weakness in the value of the dollar against other currencies.
- We figured the Fed was much further along the path of interest-rate normalization than other central banks, and that the large interest-rate differential in favour of U.S. fixed-income securities would continue to bolster the greenback.
- But, as seen in the chart, the widening rate spread no longer seems to be a driver of the currency's value.
- The dollar's decline has been an important development for global financial markets.



Source: Tullet/Prebon Information, WM/Reuters, FactSet, SEI

Bring It on Home

- The U.S. tax-reform package, will give companies the opportunity to repatriate funds held abroad at an advantageous tax rate.
- Publicly traded companies currently hold more than $2.5 trillion in foreign jurisdictions.
- This cash hoard is concentrated in the largest U.S. multinational companies. The 13 companies listed in the chart hold an aggregate $760 billion overseas.
- A survey conducted earlier in the year by Bank of America Merrill Lynch[1] found that nearly two-thirds of reporting companies would use repatriated funds to pay down debt.
- Almost half of respondents (46%) would buy back their own equity, thereby boosting earnings per share.

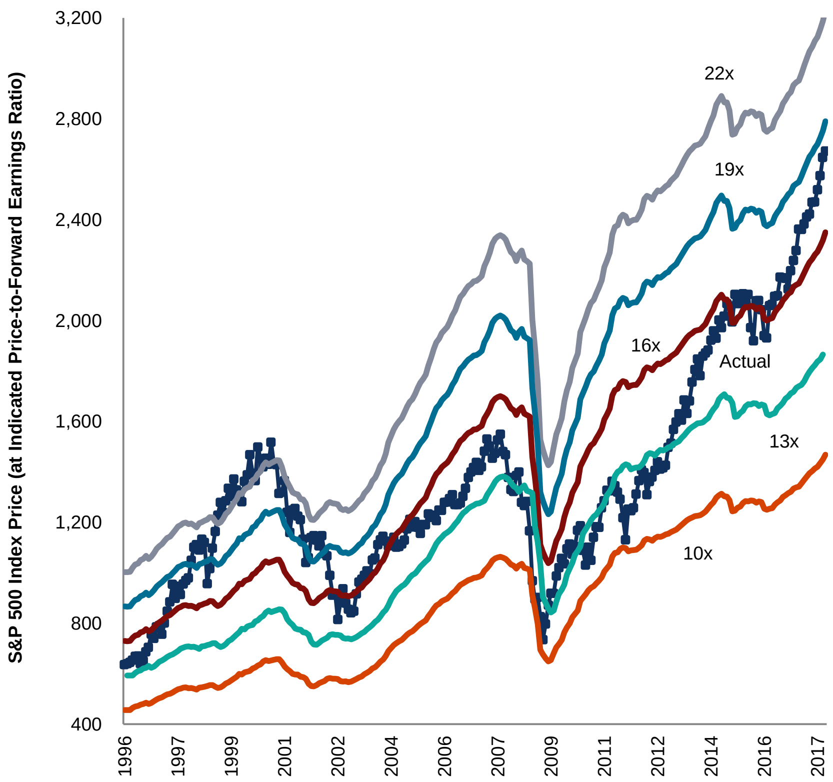


Source: Company reports, SEI

[1]2017 BofAML Corporate Risk Management Survey

Most High

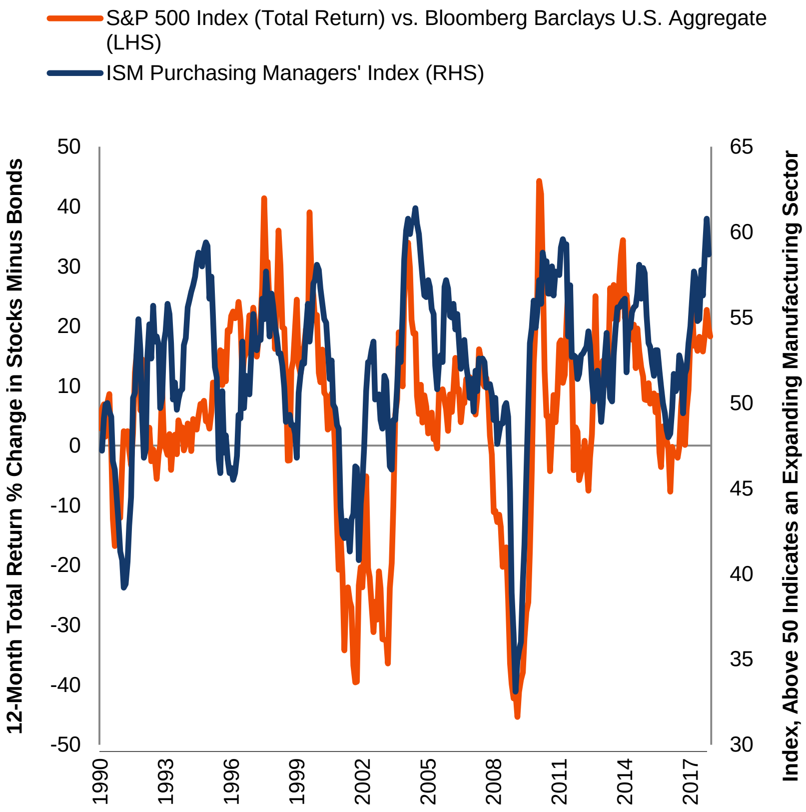
- The major worry for investors comes down to the stock market's valuation.
- This chart compares the S&P 500 price index against different price-to-forward earnings ratios.
- Economist Ed Yardeni, who originally created this chart concept, terms it the "Blue Angels" because the different p/e ratios "fly" in parallel formation like the famed U.S. Navy flight squadron, while the S&P 500 price index (the blue line with square marks) cuts through the "contrails" of the various p/e ratio levels.
- We like this chart because it not only shows how expensive the stock market is relative to history, but it also provides the current trajectory of forward operating earnings – climbing contrails mean earnings estimates are on the rise, supporting a higher stock price at a given price/earnings ratio.



Source: Standard & Poor's, Yardeni Research Inc., SEI

Going Down?

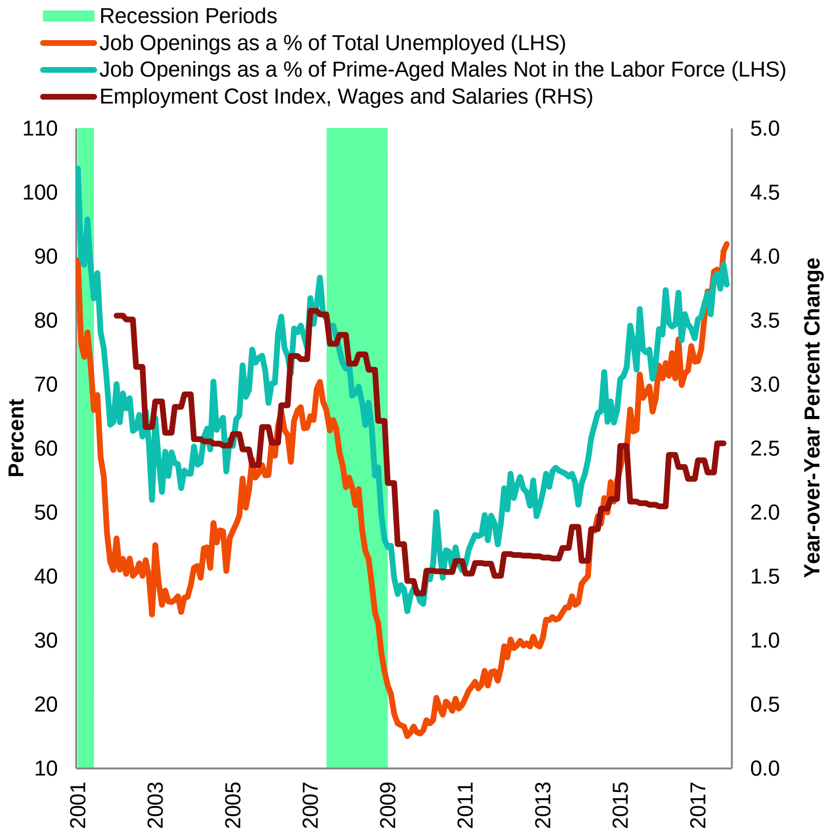
- The chart compares the index level of the U.S. Manufacturing Purchasing Managers Index (PMI) against the 12-month change in the S&P 500 Total Return Index minus that of the Bloomberg Barclays Aggregate Bond Index.
- Although not perfect, a rising PMI is more often than not associated with relative strength in equities versus bonds; as the PMI falls, the bond market is the better relative performer.
- If the PMI Index fades toward the 50 demarcation line (a value below 50 signals a contraction in the manufacturing sector), we could well see a curbing of the market's current exuberance.
- In order to get really concerned, though, we need to see a more aggressive swing in Fed policy toward monetary tightness. We don't see that happening in the coming year.



Source: Bloomberg Barclays, Institute for Supply Management, Standard and Poor's, SEI

Jobs Go Begging

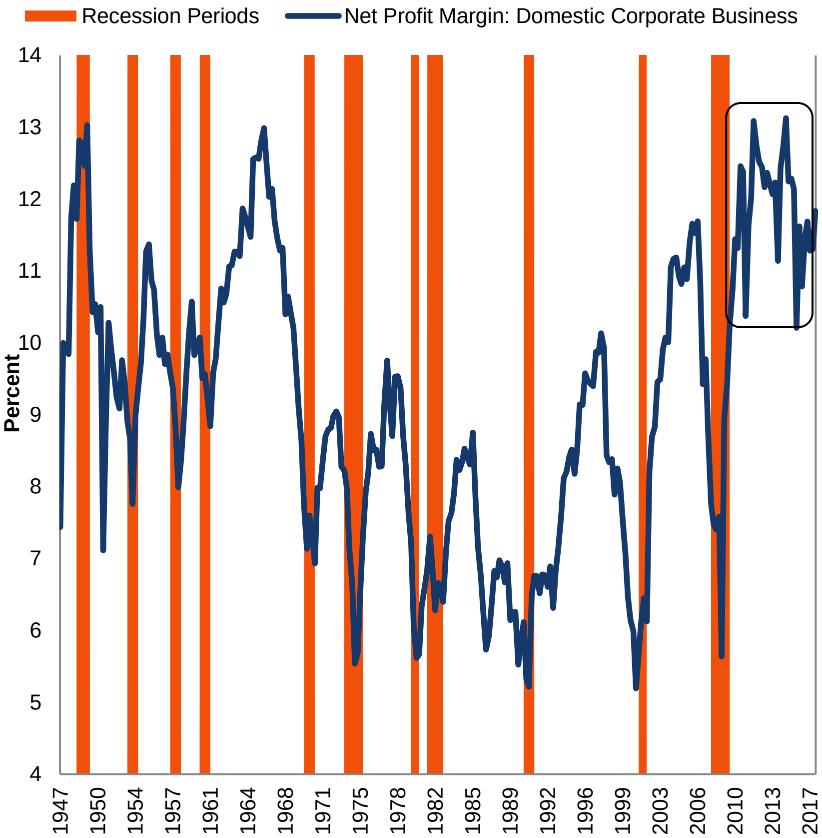
- Most labour-related statistics strongly suggest that the U.S. economy is approaching full employment.
- The chart shows that jobs are going begging for lack of qualified candidates.
- According to the U.S. Department of Labor, there were six million job openings in the non-farm sector as of October. This is equivalent to 92% of the officially unemployed, which totaled 6.5 million persons that month.
- It also amounts to 85% of all the prime-aged males who are not currently in the labour force.
- The first statistic is the highest since the jobs opening data were first collected in 2001; the latter is the highest since near the peak of the previous expansion in 2007.
- It's possible that next year is the year when inflation pressures finally begin to build in the U.S.



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

Ten Years Gone, Holdin' On

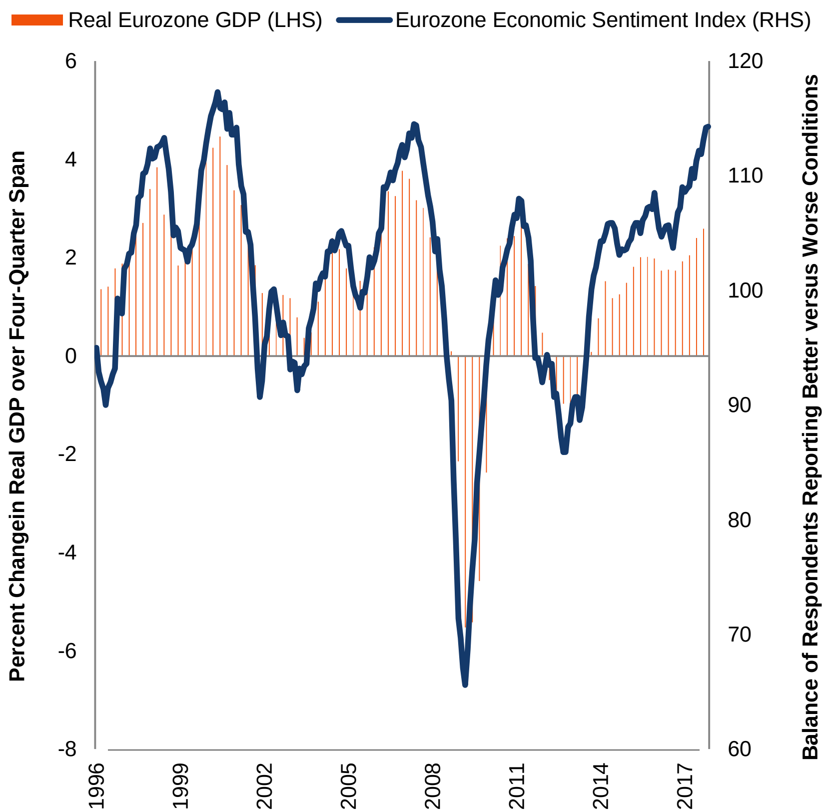
- U.S. profit margins have held steady at unusually high levels throughout this long expansion.
- While we have seen some acceleration in wages and salaries as measured by the Employment Cost Index (ECI), the year-over-year increase remains a low 2.5%.
- At the peak of the last cycle, U.S. wage increases were running a full percentage-point higher than they are now.
- Meanwhile, unit labour costs (the difference between the growth in total employee compensation and the change in productivity) registered an outright decline over the 12 months ended September.
- This means U.S. companies have been able to maintain profit margins without resorting to price increases.



Source: Bureau of Economic Analysis, ECRI, Philosophical Economics, SEI

Europe Back in the Light

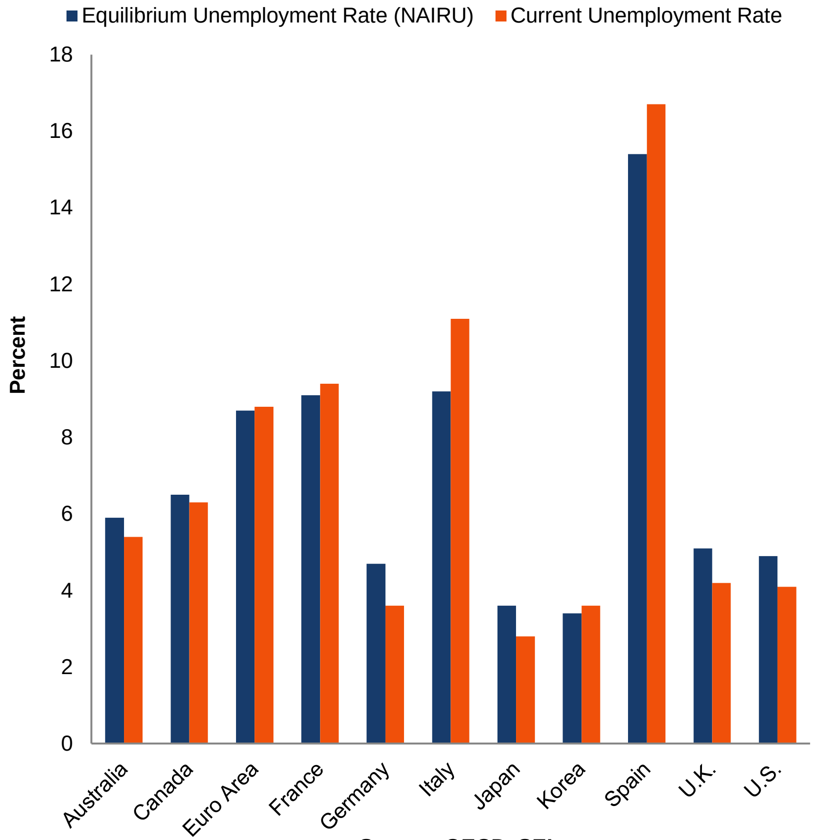
- For most of the past decade, Europe was the land of ice and snow economically.
- That's not the case anymore. Through the third quarter, the Eurozone economy, as measured by inflation-adjusted GDP, advanced 2.6% on a year-over-year basis.
- By comparison, the U.S. grew only 2.3% over this period while the United Kingdom's increase amounted to only 1.5%.
- More timely data reveal economic acceleration through the fourth quarter. The Eurozone Purchasing Managers Index hit a record high in November. The services sector, meanwhile, reached its highest level since early 2011. The European Commission's Economic Sentiment Index, highlighted in the chart, is a broad measure of European business confidence within the European Union. It has a strong correlation with Eurozone GDP growth. It, too, continues to accelerate. It now has attained the same level as the previous pre-crisis peak in 2007.



Source: European Commission, Eurostat, SEI
As of 30/09/2017

Full Employment: Your Time is Gonna Come

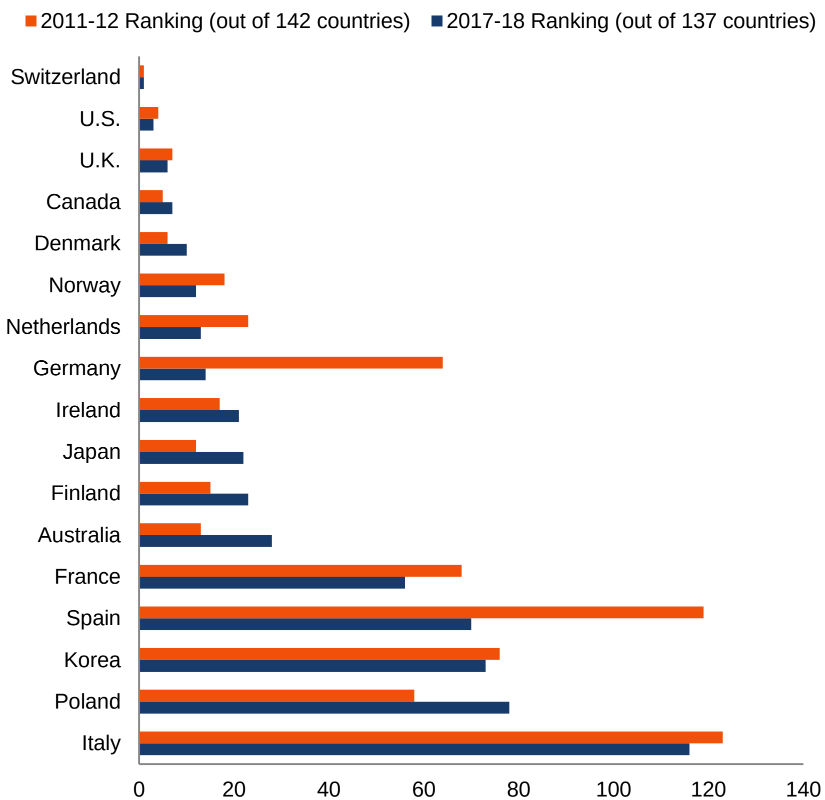
- Despite the evident momentum in the regional economy, the European Central Bank looks for only a 2.3% gain in 2018 and a further deceleration in growth to 1.9% in 2019.
- This strikes us as unduly cautious. We suspect that the disappointing economic experience of the past decade has turned European economic forecasters into congenital pessimists.
- Economists at the Organisation for Economic Co-operation and Development (OECD), for example, peg the so-called non-accelerating inflation rate of unemployment (NAIRU) in the Euro area at 8.7%, with huge variations among countries.
- The chart depicts the NAIRU of selected countries. Over the 12 months ended October, the euro area's unemployment rate has declined a full percentage point to 8.8%.
- Does anyone truly believe that the labour market in Europe has reached the level that will touch off wage inflation?



Source: OECD, SEI
As of 31/10/2017

Ev’ry Day I Work So Hard

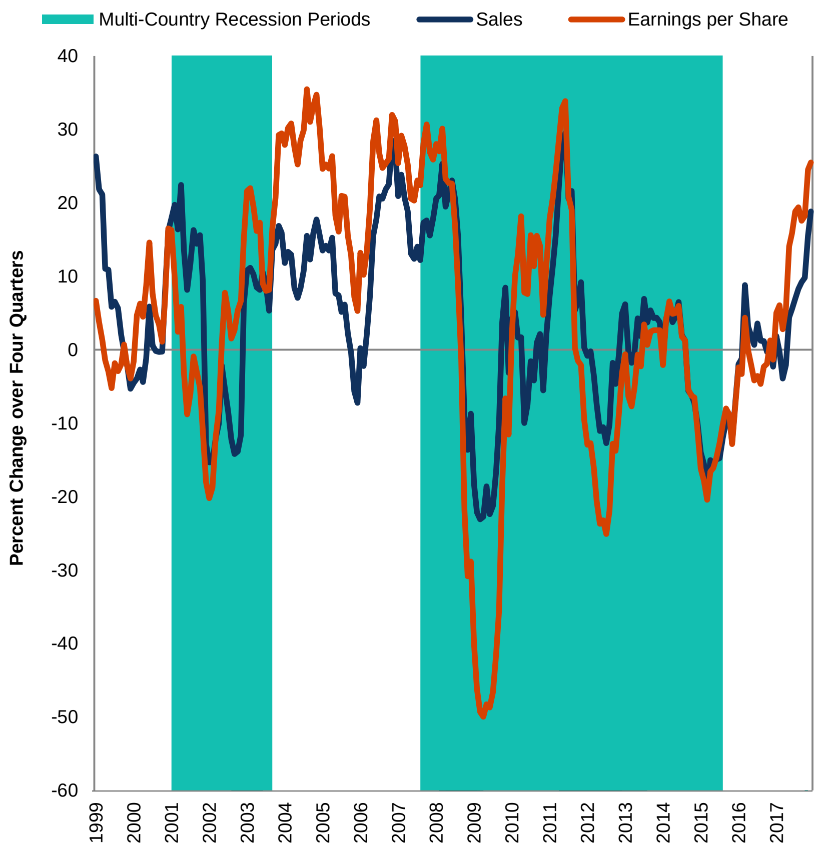
- According to the World Economic Forum’s annual report on global competitiveness, the high-income countries of Western Europe have made important strides in improving labour market efficiency since 2011-2012.
- The Forum measures labour market efficiency by a variety of measures. They include (among others) labour-employer relations, wage flexibility, hiring and firing practices, redundancy costs, the impact of taxation on the incentive to work, pay and productivity, and female participation in the labour force.
- The chart shows that Germany has done particularly well in this regard; the country has vastly improved its hiring and firing practices and is making decent progress in the category of wage flexibility.
- France, Italy, Spain and the Netherlands – the next four largest Eurozone economies – have also recorded improvements in their labour-market efficiency rankings over this period.



Labour Market Efficiency Country Ranking (1=Best)
Source: World Economic Forum, SEI

Flying High

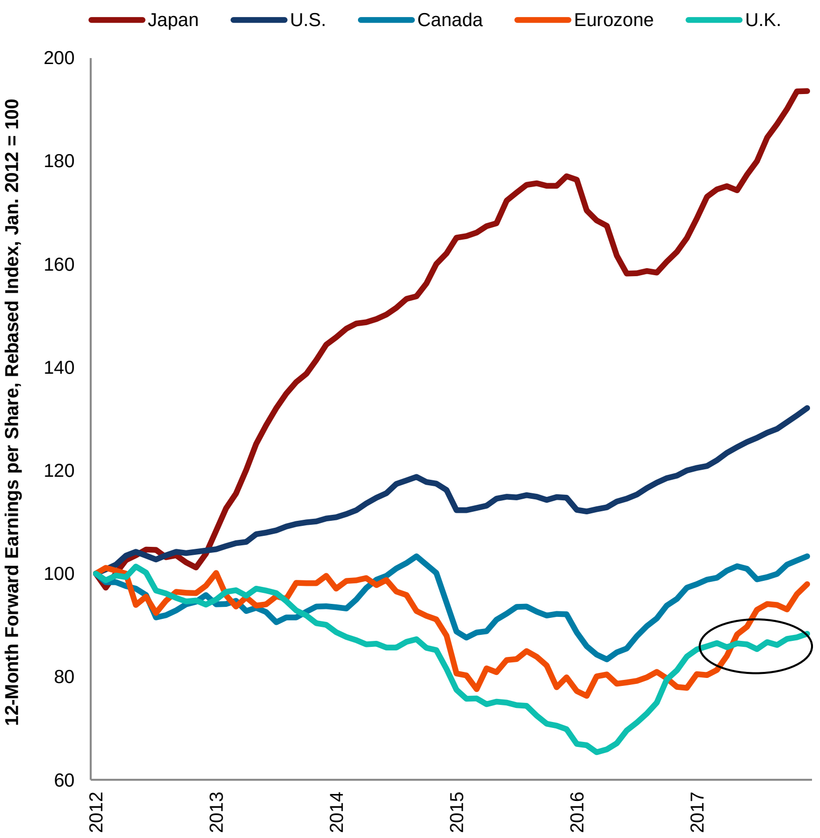
- We're more optimistic on the Eurozone's economic prospects than we have been at any time since the start of the Greek debt crisis in 2010.
- Given our view that the region is a long way from employment levels that will stir inflation pressures, we expect monetary policy to be supportive of growth throughout the coming year, even as the European Central Bank proceeds with its taper of quantitative easing.
- Thus the way is clear for further growth in economic activity during the year ahead.
- We should see a continuation of the past year's revival in corporate revenues and earnings. The chart highlights the fact that analysts' forward estimates for revenues have gained more than 15% in the past year, while earnings per share are projected to be up by 25.5%.
- These are the best forward views recorded since the early recovery stage following the global financial crisis.
- Unlike that earlier episode, we do not anticipate the rebound to be cut short by another periphery debt crisis.



Source: ECRI, MSCI, SEI

U.K. Earnings Lose Their Mojo

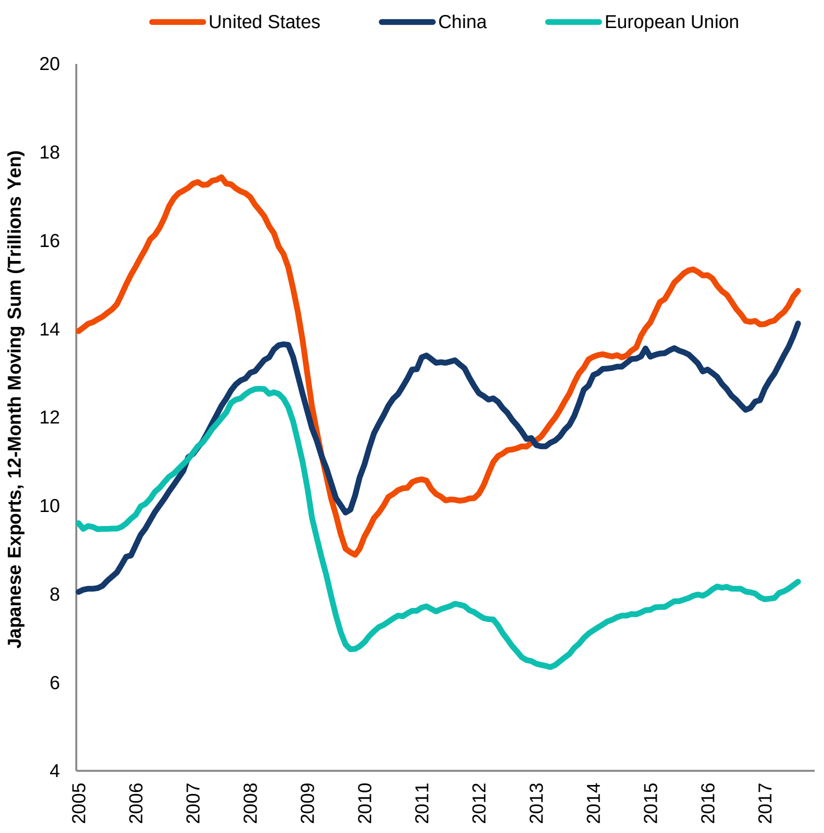
- Sterling's depreciation has helped to prop up earnings, although the bulk of the improvement in one-year forward earnings per share came in 2016.
- The chart suggests that analysts are more cautious on the U.K.'s earnings prospects than on those of other major economies.



Source: MSCI, SEI

Japanese Exports: I Like the Way You Move

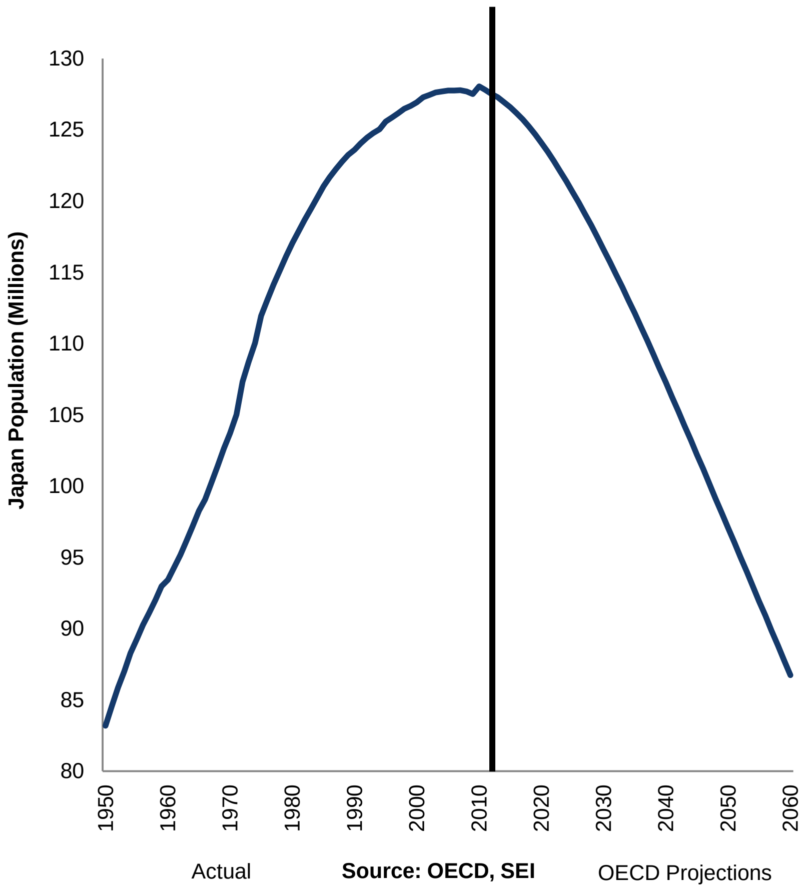
- The country is finally benefiting from the global economic recovery.
- The chart highlights the fact that exports to China are growing particularly sharply.
- Exports to the U.S. and the European also have accelerated, but not to the same extent.
- The share of Japanese exports to China is rising as well, reaching 19% of the total. That's about the same as the share of exports going to the United States.



Source: International Monetary Fund, SEI

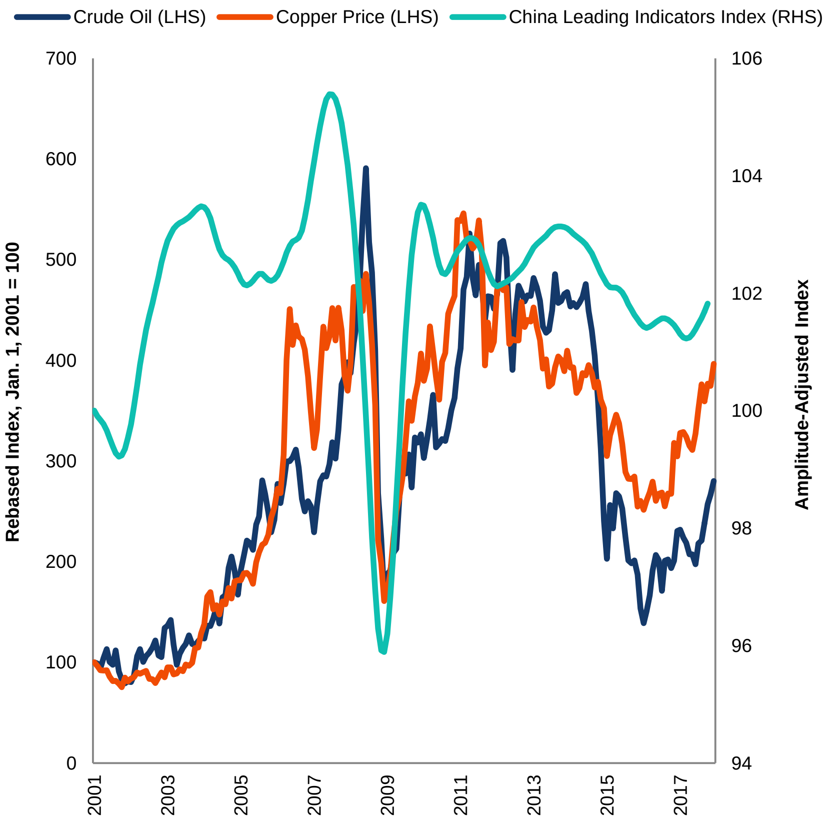
I Think I Might Be Sinking

- Although there have been rumblings that the Bank of Japan would like to take a step away from the extraordinary monetary policies that have been in place since the financial crisis, the central bank might find it difficult to do so.
- Domestic demand remains too weak, and the population has begun contracting.
- Indeed, as the chart highlights, the population decline is expected to accelerate in the decades ahead.



A Whole Lotta Love for China

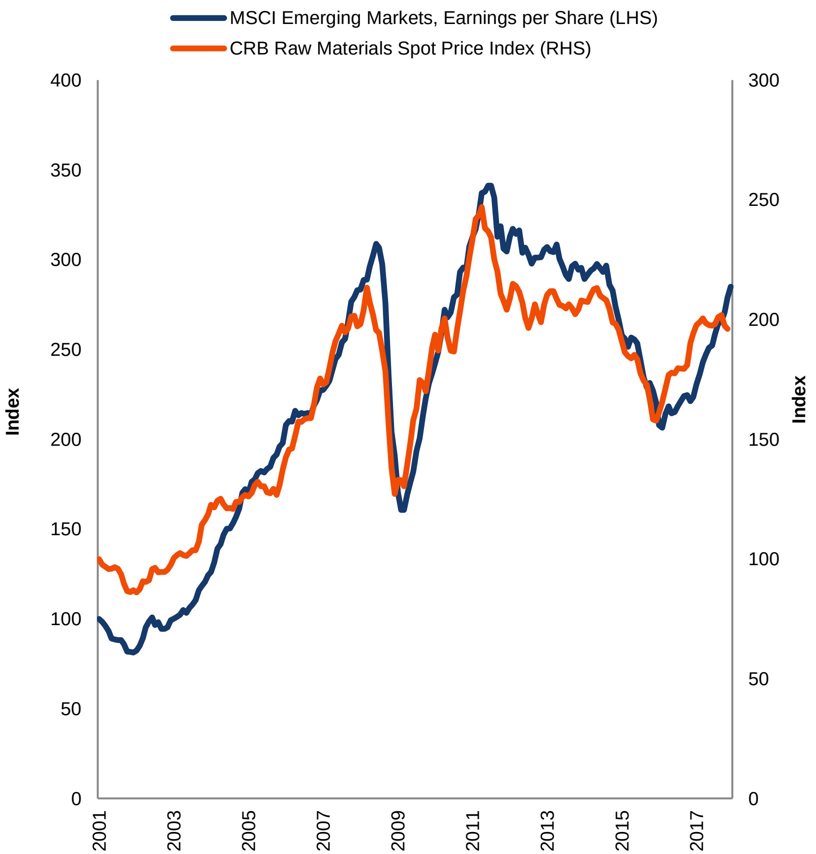
- The OECD's amplitude-adjusted Leading Economic Indicators statistic suggests that China's economy will continue to grow at an above-trend pace in the months ahead.
- This OECD measure tracks the money supply, turnover on the Shanghai Stock Exchange, crude steel and chemical fertilizer production, auto manufacturing, building construction, and the overseas orders of some 5000 industrial enterprises.
- As seen in the chart, the swings in China's leading indicators correlates to an extent with the ups and down of copper and oil prices. If China can maintain its positive momentum, commodity prices should continue to rally as well.



Source: Commodity Research Bureau, London Metal Exchange, OECD, SEI

Where Commodities Go, Emerging Market Earnings Should Follow

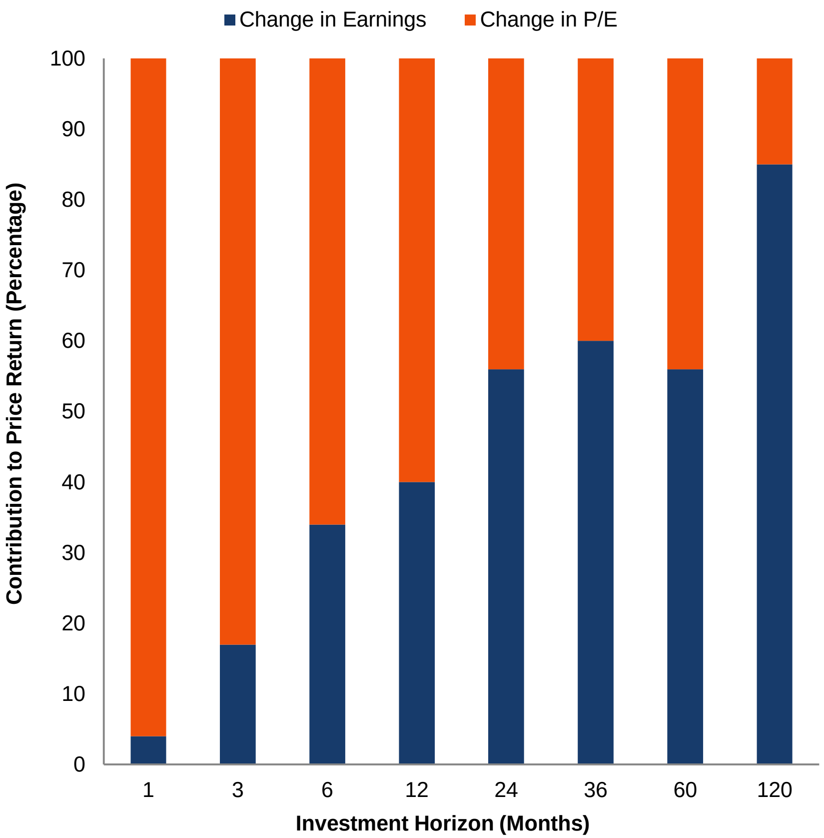
- This chart underscores the strong correlation of commodity pricing and the earnings per share of the components of the MSCI Emerging Markets index, even though one might think that the move into higher-valued activities by the largest and most advanced countries would reduce that connection.
- Estimated forward earnings jumped 37% in U.S. Dollar terms since the trough in the Commodity Research Bureau's raw materials price index. In other words, more than half of the equity gain in total return terms over this timeframe has been backed by profits growth.
- The rise in the forward MSCI Emerging Markets price-earnings ratio, from 10.5 in February 2016 to 12.4, still leaves it at a deep discount to that of the MSCI World forward price/earnings ratio.



Source: Conference Board, MSCI, SEI

There's Still Time to Change the Road You're On

- It's important to remember that there's a certain serendipitous quality to short-term movements in the stock market.
- The chart breaks down the change in the S&P 500 price return between the contribution provided by operating earnings and by the change in the price-to-earnings ratio versus various investment horizons.
- In any given month, precious little of the change in the stock market can be attributed to earnings—on average less than 5% of the return. Even at the end of one year, changes in valuation dominate. This reflects the importance of investors' expectations in the price-setting process.
- Over a two year time horizon, however, fundamentals start to matter more than investor psychology. But it's not until one looks at the market over a ten-year time frame that earnings become the primary driver of equity value.
- That's why we focus the bulk of our asset allocation on strategic investing, employing long-term capital market assumptions.



Source: Myles Zyblock, Dynamic Funds; SEI

Index Standardised Returns

	1 year to 31-Dec-17	1 year to 31-Dec-16	1 year to 31-Dec-15	1 year to 31-Dec-14	1 year to 31-Dec-13
Bloomberg Barclays U.S. Aggregate Index	3.54%	2.65%	0.55%	5.97%	-2.02%
CRB Raw Materials Spot Price Index	5.00%	23.09%	-19.41%	-5.90%	0.85%
MSCI Canada Index (Net)	16.07%	24.56%	-24.16%	1.50%	5.63%
MSCI Emerging Markets Index (Net)	37.28%	11.19%	-14.92%	-2.19%	-2.60%
MSCI EMU Index (Net)	28.06%	1.34%	-1.42%	-8.39%	28.94%
MSCI Japan Index (Net)	23.99%	2.38%	9.57%	-4.02%	27.16%
MSCI United Kingdom Index (Net)	22.30%	-0.10%	-7.56%	-5.39%	20.67%
MSCI USA Index	21.90%	11.61%	1.32%	13.36%	32.61%
MSCI World Index (Net)	22.40%	7.51%	-0.87%	4.94%	26.68%
S&P 500 Index	21.83%	11.96%	1.38%	13.69%	32.39%

Data refers to past performance. Past performance is not a reliable indicator of future results. In USD.

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QIR: Important information

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CONTINUED OVERLEAF

QIR: Important information (continued)

In addition to the usual risks associated with investing, the following risks may apply:

- 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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