Commentary

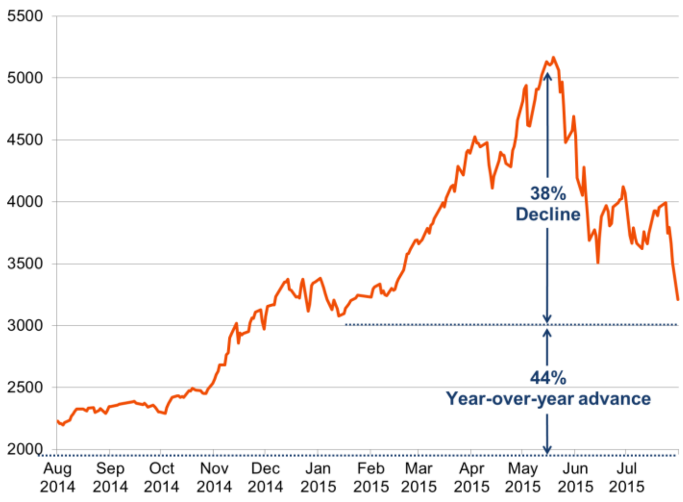
August 2015

China Sneezed; Will the Rest of the World Catch a Cold?

- Mainland Chinese equities have plunged despite intervention by the People's Bank of China.
- Global markets have fallen too, but is this China driven or the product of concerns over interest rate hikes?
- Already weak commodity prices have tumbled further due to growth concerns.

Declines in mainland Chinese equities have been grabbing headlines since plunging from all-time highs in June. Other emerging markets have been falling as well, with the U.S. joining over the past week. But a little perspective is probably necessary. Chinese stocks have fallen about 40% since the mid-June peak, but even after this precipitous decline, they are still up over 40% in just the past twelve months and essentially flat year to date. Investors have been concerned about the timing, speed and size of tapering and eventually interest-rate hikes by the Federal Reserve (Fed) since at least 2013. Many investors believe the Fed will increase rates in 2015, possibly as early as next month, but this seems less likely by the day. The current market turmoil does not seem proportionate to those concerns.

Exhibit 1: China, Down but Not Out
Chinese Equity Performance Over the Past 12 Months

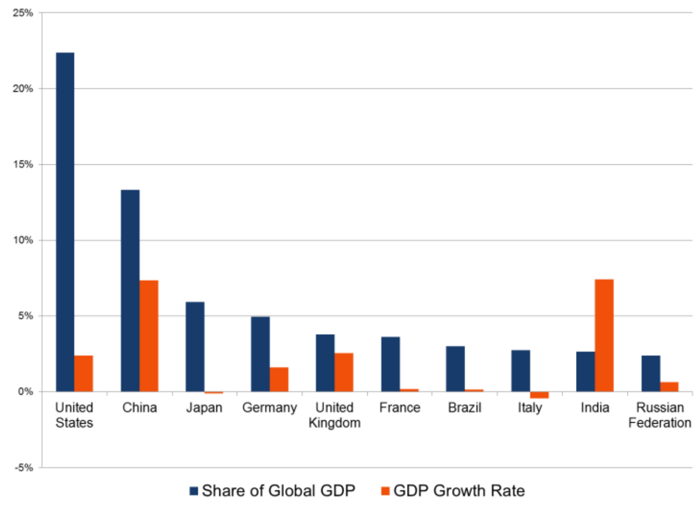


Source: SEI, Shanghai Stock Exchange Composite Index as of 8/24/15.

China Sneezed

Recently, it's been popular to say that "When China sneezes, the rest of the world catches a cold" to colloquially describe China's impact on global economic growth. While the Fed is playing a role, the actual culprits seem to be concerns about China's financial system in general, high debt load and a relatively less optimistic economic outlook. China's inner workings are still opaque and it is never easy to see what is happening there. The Chinese economy has grown at an impressive rate and now rivals the U.S. based on several measures. Given its size and growth rate, China's economy has been the engine driving global growth. While global economic growth has been sluggish during the recovery from the financial crisis, China's growth still remains a robust 7.0% for the annual period ending June 30, 2015, according to official sources; however, many investors believe the Chinese government continues to overstate this measure. Still, even at half that rate, the country's growth would outstrip all but the fastest-growing economies across the globe and none of those economies approach China's size.

Exhibit 2: Global Growth Picture



Source: SEI, World Bank, Data for annual period ending 12/31/14.

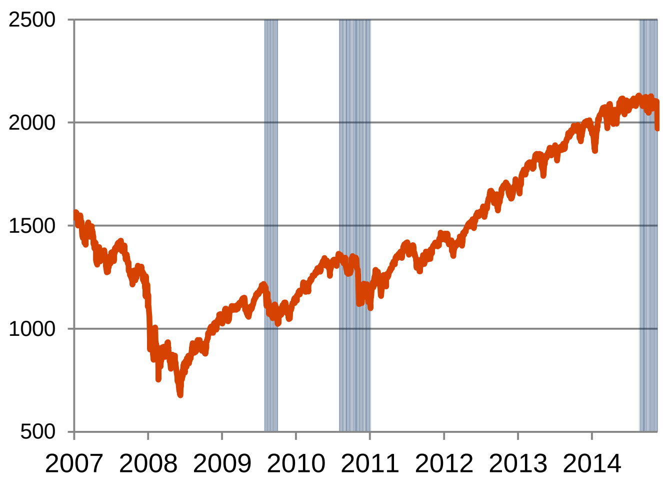
The People's Bank of China (PBOC) has lowered interest rates, provided liquidity for brokerages to buy stocks and may be considering further actions such as further easing of reserve requirements for banks. In the wake of the stock plunge the PBOC also devalued China's currency (the renminbi) but this was seen as more of a move to allow the currency to float more freely as part of a play to be included in the Special Drawing Rights Fund administered by the International Monetary Fund. An indirect benefit of this move is that a weaker currency should provide a modest boost to the attractiveness of Chinese exports. The renminbi had been quite strong as the currency basket it was pegged to prominently features the U.S. dollar which had appreciated against virtually every currency except the renminbi. Further support from the PBOC may be lacking, however. While the currency will be allowed to float more freely now, a currency trading band may still limit the central bank's ability to provide further support to equity markets as any actions will also have to take into account the potential impacts on the currency.

Does the U.S. have Immunity?

The S&P 500 Index opening price on August 24, 2015 would constitute a correction (a decline of at least 10%) from the high price achieved on May 21, 2015. Despite a few close calls, the S&P 500 has not experienced a correction since 2011, when it declined amid a protracted Congressional struggle over the national debt ceiling and a U.S. credit-rating downgrade.

While selloffs are not pleasant experiences, the four-year run since the 2011 correction represents double the average timespan between corrections – roughly every other year going back to the 1950s. Again though, a little perspective is needed.

Exhibit 3: The Crisis Got the Horn of the Bull



Source: SEI, S&P 500 Index as of 8/24/15. Shaded areas represent corrections within the current bull market.

It has been an impressive bull run, in terms of both gains and durability. The S&P 500 has cumulatively gained about 180% from March 9, 2009 through today's opening price, ranking fourth (behind the 1987-2000, 1949-1956 and 1982-1987 periods) for returns going back to the early 1930s[1]. At more than 77 months, this bull market would tie for the third-longest (behind the 1987-2000 and 1949-1956 periods) over the same time frame.

Who has the Sniffles?

Many emerging-market countries are net exporters of natural resources, of which crude oil may be the most prominent. This is true of the large emerging economies of Russia and Brazil, but China is a notable exception. Both Russia and Brazil have struggled with lower oil prices resulting from a supply glut, while Russia has also been dealing with the fallout from tensions in Ukraine. On the other hand, China's growth is fuelled by a steady stream of commodity imports. Obviously when China's growth slows, demand for natural resources can be diminished, but lower commodity prices are not all bad news. For example lower crude oil prices should provide some relief for U.S. consumers; Japan and Europe should benefit too.

SEI's View and Positioning

All this turmoil is revealing a mixed outlook for global growth pockets of strength and weakness in emerging markets. Commodity-producing economies and those with close ties to China are struggling. Other countries, such as India, are neither commodity producers or closely tied to China. India is itself a fast growing economy with a favorable growth outlook, and is viewed positively by SEI.

Corporate earnings in developed markets will be impacted, but we believe there will be some resiliency there. The U.S. was probably overdue for a healthy bull market correction. Valuations were getting stretched and equity opportunities had actually become more appealing in Japan and Europe on a currency-hedged basis, although we have some concerns about the economic exposures of Germany and Japan to China. U.S. equities are still not cheap from a valuation perspective. That said, selling in the U.S. seems overdone and we still expect the economy will continue to improve gradually with no signs of an impending recession.

Many of SEI's investment strategies have exposure to emerging-markets equity and debt funds. These allocations are strategic (long term) in nature, modest in size when compared to developed market allocations, and we expect will remain. Additionally, the managers within those funds have been tasked with managing emerging-markets portfolios and will continue to do so with exposure to China and a diversified mix of other emerging-market countries. Keep in mind, exposure to China A shares is fairly limited given government restrictions on foreigners buying Chinese stocks and bonds. The bulk of Chinese equity exposure has come from H shares registered in Hong Kong, which have been relatively less volatile. Within emerging debt markets, which are primarily sovereign, our

[1] Prior to March 4, 1957 data is for the S&P 90 Index which consisted of the 90 largest U.S. publically traded companies.

managers are focused more on countries with improving balance sheets and current accounts. These types of countries are often candidates for upgrades and in fact many have already been upgraded to investment-grade debt. Higher rated securities have less default risk and tend to perform better in times of turmoil. Within equities, a long-term cyclical trend of a burgeoning middle class is still intact. Managers remain positioned for this with a smaller cap bias as these companies tend to have greater exposure to domestic demand. Some managers have even viewed the weakness in Chinese stocks as a buying opportunity.

When looking at expected manager performance, it's important to note that some of SEI's managers will be expected to perform well in this environment, while others may not. Funds are constructed with multiple managers, which employ different styles and investment techniques. Managers hired by SEI also employ what we consider to be disciplined and repeatable investment processes. Therefore we don't expect wholesale changes to underlying portfolios, but managers will adjust holdings as appropriate within their own unique strategies.

SEI's Portfolio Strategies Group makes strategic allocation decisions, as well as tactical positioning decisions. At this time, the turmoil has not resulted in any changes to strategic positioning and none are being contemplated. As always, tactical positions are being evaluated, and new opportunities are being assessed in light of recent market turmoil.

Market downdrafts hurt, but they also generate new opportunities for patient investors who remain calm during times of trouble.

Definitions and Disclosures

The **Shanghai Stock Exchange Composite Index** is an unmanaged index that consists of all the A shares and B shares listed on the Shanghai Stock Exchange.

The **S&P 500 Index** is an unmanaged, market-weighted index that consists of the 500 largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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