Economic Outlook

First Quarter 2018

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A New Phase for Equities

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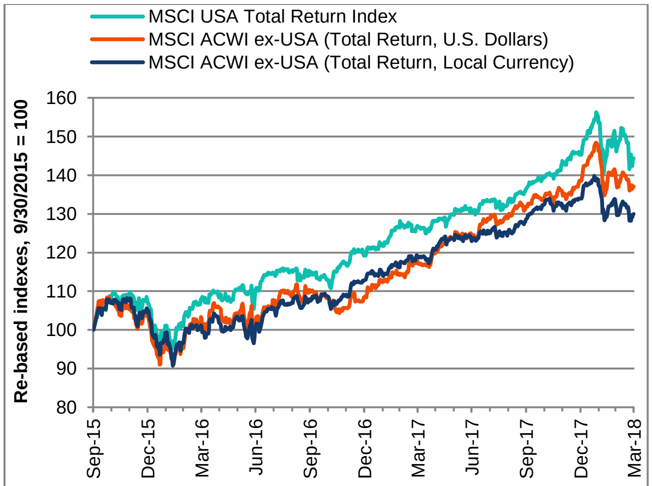
- We suspect the bull market in U.S. equities is somewhere near the beginning of the end.
- This particular phase can last a few years if all goes well, but the ride will likely be bumpier than in recent years.
- We believe that economic fundamentals still justify further gains in U.S. and global equity prices.

Now this is not the end. It is not even the beginning of the end. But it is perhaps the end of the beginning.
-U.K. Prime Minister Winston Churchill at the Lord Mayor's Luncheon at Mansion House in London, November 10, 1942

That famous quote from the illustrious British Prime Minister was referencing the Allied victory at the second battle of Al Alamein, Egypt, during World War II. It proved to be the decisive engagement in the North African Campaign, a battle between the Axis Powers of Germany and Italy and the Allied Powers led by the U.K. and assisted by Commonwealth nations with U.S. air power, that allowed the Allies to dominate the Mediterranean Sea and prepare for the invasion of Italy. Churchill was right—it was only the end of the beginning. The war in Europe would continue for an additional two-and-a-half years.

We last referenced Churchill's quotation in our third-quarter 2015 Economic Outlook, suggesting that the bull market in global equities wasn't ending or even at the beginning of the end. At the time, financial markets were undergoing a spate of increased volatility, but we were convinced that the correction would be short-lived and of limited magnitude. As Exhibit 1 illustrates, this turned out to be the correct call.

Exhibit 1: Never, Never Never Give Up



Source: MSCI, SEI

Although equities didn't bottom out until late January/early February 2016, the subsequent rally was strong and prolonged. From the end of the third quarter in 2015 through the end of March 2018, the MSCI USA Index (Total Return) leapt a cumulative 44%, while the MSCI ACWI ex-USA Index (Total Return) climbed 30% in local-currency terms and about 37% in U.S. dollar terms.

And so, in the Churchillian scheme of things, where are we now? Our guess is that the bull market in U.S. equities is somewhere near the beginning of the end, while it may be closer to the end of the beginning in other countries. Let's be clear: we are NOT saying that the bull market is ending in any part of the world, any time soon. Rather, we are noting that the fundamental, technical and psychological factors driving equity-market performance appear consistent with the latter stages of an up cycle. If all goes well, the duration of this particular phase can last a few years, but the ride will likely be bumpy. We still do not see many serious signs of overvaluation or economic imbalances that would suggest imminent danger of a severe correction of 15% or more, much less a devastating bear market on par with the 2008-to-2009 experience.

The Market Cycle

Let's examine the economic- and market-related factors that characterize a late-cycle bull market. Exhibit 2 provides a stylized cycle analysis of equities and fixed-income asset classes. During an expansion phase, the economy grows at a healthy pace, interest rates begin to rise and the yield curve tends to flatten (yields and prices move inversely). Strong profitability leads to increasing investor optimism and rising earnings multiples. Equities perform well. Fixed-income markets, meanwhile, come under pressure as the central bank begins to nudge policy rates higher. Credit spreads continue to tighten as defaults reach low levels and credit quality improves despite the re-leveraging of corporate and consumer balance sheets.

Exhibit 2: Riding the Cycle

	EXPANSION	STRESS	DISTRESS	RECOVERY
EQUITY	➢ Mid-stage bull market ➢ Real earnings growth continues at a healthy pace ➢ Price multiples expand	➢ Late-stage bull market ➢ Real earnings grow but at a slower pace ➢ Price multiples are flat or expanding based on higher prices and slowing growth	➢ Bear market ➢ Real earnings growth is falling ➢ Price multiples fall from elevated levels	➢ Early-stage bull market ➢ Real earnings growth is rebounding ➢ Price multiples can contract based on strong earnings but then turn around
FIXED INCOME	➢ Economy re-levers, interest rates begin to rise ➢ Government yield curve begins to normalize ➢ Credit spreads are tightening	➢ Slowing debt growth; central bank tightening ➢ Government yield curve shifts upward, flattens ➢ Credit spreads are tight; defaults pick up	➢ Credit dries up; central bank easing ➢ Government yield curve shifting downward ➢ Credit spreads are widening	➢ Deleveraging and stimulus continue ➢ Government yield curve moves down, steepens ➢ Credit spreads begin to narrow

Source: SEI

In the final (stress) phase of the bull market, the advance in equity prices becomes more labored. Economic growth tends to slow and inflation accelerates as labor shortages develop and other input prices increase. Profit margins decline and earnings flatten out, although the price-to-earnings ratio can remain elevated or even expand. Fixed-income yields tend to rise on inflation fears and additional monetary policy tightening by the U.S. Federal Reserve (Fed).

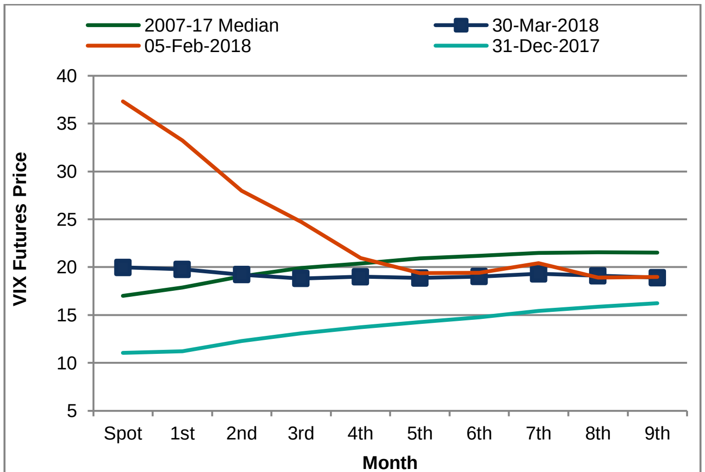
The yield curve shifts upward and narrows, with the spread between short- and long-term rates approaching zero; the yield curve usually inverts (short-term rates rise above long-term yields) 6-to-12 months before a recession. During this stress phase, corporate credit spreads are tight but can begin to widen. Exhibit 3 takes a deeper dive into the behavior of various market and economic indicators during the different phase of the cycle.

	EXPANSION	STRESS	DISTRESS	RECOVERY
MARKET INDICATORS	➢ Credit spreads low and likely slowly narrowing ➢ Default rates low and likely falling ➢ Valuation not "cheap" historically, cross-sectional dispersion is narrowing ➢ Chicago Board Options Exchange Volatility Index (VIX) low, likely <20 ➢ Forex (FX) volatilities low, carry trade operating well ➢ Asset prices generally rising at predictable pace	➢ Credit spreads rapidly widen to high levels ➢ Defaults rising but generally late in cycle/ expectations of recovery highly uncertain ➢ VIX rapidly increases to high levels (30+) ➢ Valuation spreads widen quickly, rapidly passing through "fair value" relative to historical levels ➢ Asset prices quickly falling	➢ Range-bound market trading, testing of relative highs and lows ➢ Cross-sectional dispersion among equities high, with many short-term reversals ➢ VIX likely off worst levels but high relative to expansion (25-35) ➢ Defaults increasing at a much slower rate, expectations for asset recoveries becoming less volatile but not yet increasing	➢ Credit spreads high and narrowing ➢ Valuation spreads high relative to history and narrowing, cross-sectional dispersion also narrowing ➢ Foreign exchange volatility high and narrowing ➢ Defaults have peaked, expectations of recoveries improving
ECONOMIC INDICATORS (often lag market indicators by two quarters)	➢ Asset bubbles slowly forming (likely unseen) ➢ Positive gross domestic product (GDP) outlook ➢ Consumer confidence rising and high, near the end of the cycle ➢ Unemployment falling and generally low, near the end of the cycle ➢ Emotional cycle of greed	➢ Asset bubble pops ➢ Most economic indicators very slow/late to adjust (consumer confidence/sentiment will be first) ➢ Emotional cycle of fear	➢ Consumer confidence very low but falling at a slower rate ➢ GDP slowing ➢ Unemployment rising ➢ General emotion is despair	➢ Asset bubbles reflate toward fair value ➢ Most economic indicators very slow/late to adjust (consumer confidence/sentiment will be the first) ➢ Emotional cycle of relief

Source: SEI

Although we saw the Chicago Board Options Exchange (CBOE) Volatility Index (known by its ticker symbol, VIX) pop dramatically in February to an intraday high of 50, that move appears to have been a technical reaction to the implosion of short-volatility strategies that seek to profit from what had been a lack of financial market volatility. It certainly did not lead to the kind of plunge in equity prices ordinarily associated with a 50 reading in the VIX. Nonetheless, the Volatility Index appears to be settling into a higher trading range versus the ultra-low readings of the previous 18 months. Exhibit 4 shows the VIX futures curve at year-end 2017 as well as during the peak period of volatility on February 5, 2018. It also shows its value at the end of March 2018 and its median value between 2007 and 2017. The recent extreme gyrations are one of the few signs of stress to which bearish equity analysts can point, although longer-dated futures project a return to lower volatility levels.

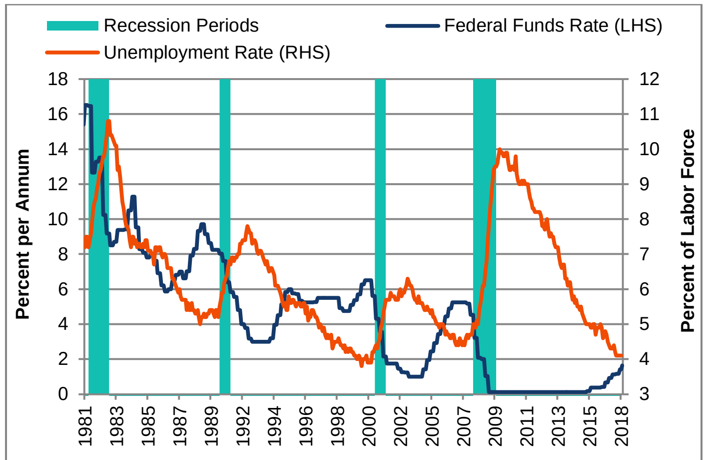
Exhibit 4: VIXatious



Source: CBOE, SEI

By our reckoning, the U.S. has been in the expansion phase since early 2016. The rest of the world generally shows signs of remaining in the latter stages of the recovery phase. This is especially true with regard to monetary policy. The Fed began to taper its bond purchases in January 2014, and ended the active phase of quantitative easing in October of that year, while continuing to reinvest interest and maturing principal. The central bank raised its policy rate for the first time in December 2015—more than six years after the peak in the unemployment rate. In previous cycles, the Fed initiated an up cycle in its policy rate within a year after unemployment began its descent. Owing to its concerns about the perceived fragility of the global expansion and the persistent downward pressure on inflation, however, the U.S. central bank refrained from boosting the federal funds rate again until December 2016. This reluctance to normalize rates came despite steady improvement in the U.S. unemployment rate, which we show in Exhibit 5.

Exhibit 5: The Fed Marches Slowly



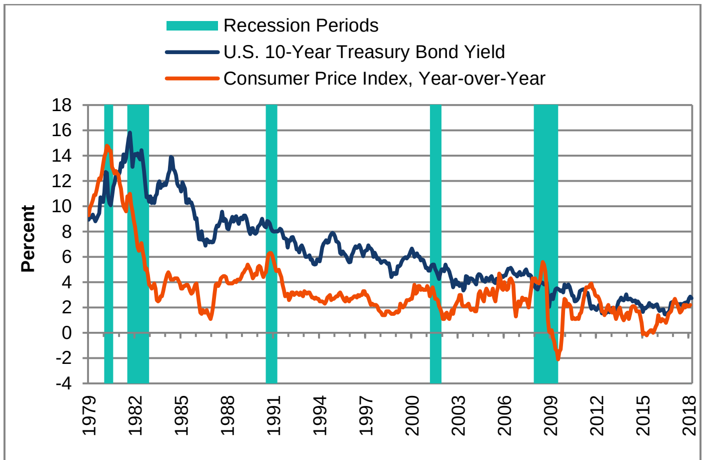
Source: Bureau of Labor Statistics, Federal Reserve Board, SEI

Last year was a different story: The Fed finally did what it said it would do, raising the federal funds rate three times. The central bank continued on the interest-rate normalization path with its most recent increase this past March, taking the rate to a target range of 1.50% to 1.75%. The Federal Open Market Committee (FOMC) continues to project two additional hikes before the end of 2018, and (unsurprisingly, in our view) revised its 2019 median forecast from two to three rate increases. We believe the FOMC may want to see how an outright contraction of its balance sheet affects the markets before making any additional changes in the projected path.

Although equity markets experienced their first real correction in some 20 months during this past February and March, the pullback does not look to us as the start of a more serious decline. We see two fundamental drivers behind the correction in equities and the return to more-volatile price action generally. Of the fundamental drivers, the first is an upward shift in investors' interest-rate expectations as the global economy kicks into a higher gear. The second is concern among market participants that recent actions on the trade front by U.S. President Donald Trump's administration will lead to a broader trade war that could upend global growth and push inflation higher sooner.

In bond markets, the attention is on yields. Exhibit 6 compares the 10-year U.S. Treasury bond yield to the year-over-year change in the consumer price index over the past four decades. On the positive side, the 10-year Treasury bond yield is still well below the levels that prevailed during the 2001-to-2007 expansion, reflecting the fact that inflation is lower as well. The chart also shows that there have been several periodic yield jumps during this generation-long bull market in bonds. Each time, those increases reversed themselves and yields moved to new lows.

Exhibit 6: The Trend Begins to Bend



Source: Bureau of Labor Statistics, Federal Reserve Board, SEI

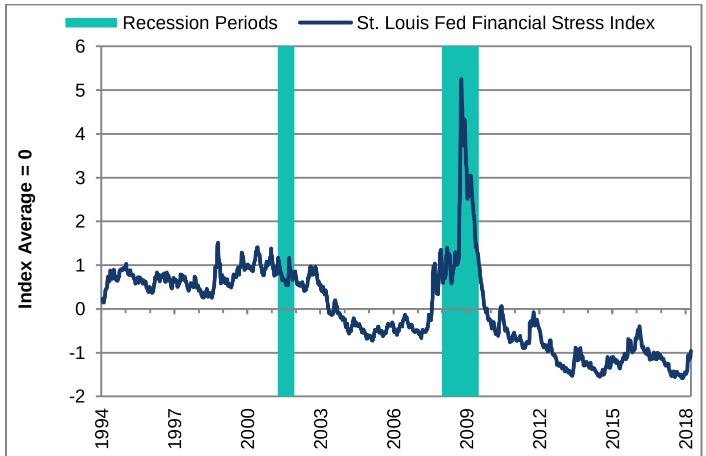
Is the current jump in the Treasury bond rate just another head fake or is it part of a prolonged bottoming process? Some observers have already announced the end of the secular bull market in bonds. Only time will tell whether this is truly the case. Bolstering the argument for higher bond yields in the years ahead is the fact that nominal Treasury bond yields are about even with inflation. Prior to this expansion, bond yields remained consistently above the inflation rate starting in 1981.

There are cyclical pressures pushing yields up from their historic lows. First, the U.S. economy is approaching, if not already past, the non-inflationary rate of unemployment. We anticipate that inflation will continue its drift higher in the months ahead. Second, the Fed has been steadily pushing up short-term rates, as we just noted. Quantitative tightening, meanwhile, will continue adding to the supply of Treasury bonds available for purchase—at a time when Treasury issuance is accelerating due to a widening government budget deficit. Finally, the rest of the world is on a stronger growth track; extraordinary monetary measures in Europe and Japan will eventually be reversed, as they have been in the U.S. The evidence strongly suggests that the U.S. 10-year bond will move above 3% this year.

The long bull market in equities and other risk-oriented assets has been sustained by the extraordinarily expansive monetary policies of the world's most important central banks. The subsequent decline in yields across the maturity spectrum reached levels never seen in the history of recorded interest rates as tracked by *A History of Interest Rates* [1]. In our view, this 37-year tailwind is turning into a headwind.

Increased financial-market volatility and the rising trend in bond yields have been duly reflected in the St. Louis Fed Financial Stress Index. Still, as shown in Exhibit 7, the index remains below its average level going back to 1994, and is nowhere near the sky-high levels reached during the global financial crisis.

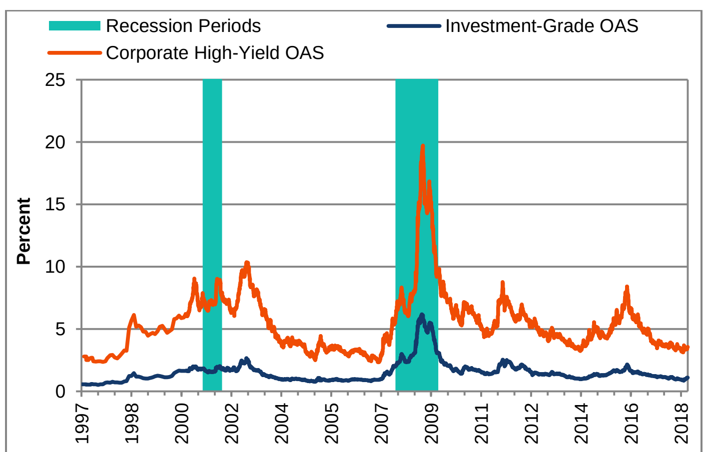
Exhibit 7: Not Stressed Yet



Source: Economic Cycle Research Institute, Federal Reserve Bank of St. Louis, SEI

The Treasury yield curve remains upward sloping and, in our opinion, still can narrow further without causing too many problems. Interest-rate spreads for investment-grade, high-yield and emerging-market debt also remain near cycle lows. High-yield bonds, in particular, should be considered the canary in the coal mine. Spreads tend to widen well before the stock market tops out. Exhibit 8 shows that the spread remains near its cyclical low. Even during the recent turbulence in the stock market, the option-adjusted spread (OAS) on high-yield bonds held surprisingly steady.

Exhibit 8: No Break-Out in Credit Spreads



Source: Bloomberg Barclays, Economic Cycle Research Institute, SEI

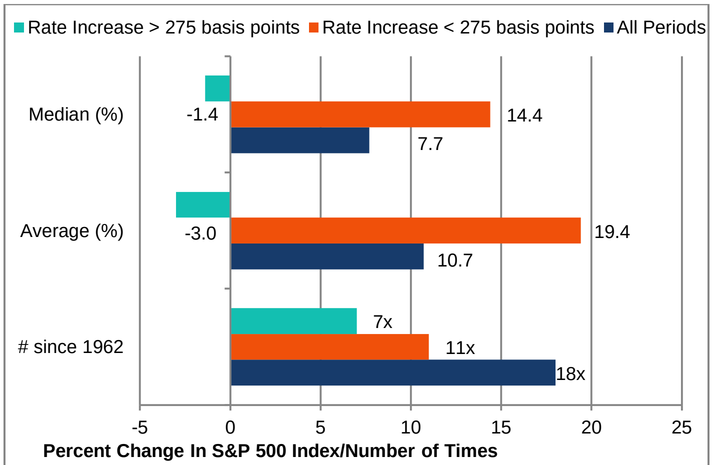
1 A History of Interest Rates, Wiley Finance Series, 4th Edition

Although the ride has turned bumpier, we believe that economic fundamentals justify further gains in equity prices. The global expansion is still alive. Earnings continue to climb. American companies' cash flows and earnings, meanwhile, are benefiting mightily from U.S. tax reform. There really are few signs that the U.S. will see a recession anytime in the next 12 to 18 months.

As we have pointed out in the past, the U.S. equity market historically has withstood the depressive impact of rising interest rates until the 10-year bond reaches a level of 4% to 5%. Owing to the structural decline in bond yields and the elevated equity valuations that have resulted, we now think it prudent to assume that the stock market will begin to struggle if the 10-year Treasury bond rate approaches 4%, the lower end of the traditional danger zone. A recent analysis by RBC Capital Markets[2] tracked S&P 500 Index performance during periods of rising bond yields. The study shows 18 occasions since 1962 during which the 10-year Treasury bond yield climbed by at least 125 basis points (1.25 percentage points) from the cyclical low point to the cyclical high. The current cycle represents the nineteenth such climb, with the bond yield up 140 basis points since the low of 1.36 set in July 2016.

Although stock-market returns are highly variable, there is a tendency for poor performance when the bond yield increases by more than 275 basis points off the lows. Exhibit 9 shows that the S&P 500 Index has logged an average price-only increase of 19.4% and a median rise of 14.4% when the trough-to-peak gain in the 10-year Treasury bond has been less than 275 basis points. When the rise exceeds 275, the average and median S&P 500 Index price change totals -3.0% and -1.4%, respectively.

Exhibit 9: Yields Need to Rise More Before a Bull Turns into a Bear



Source: RBC U.S. Equity Strategy, Standard & Poor's, SEI

Investors should take some solace in the thought that interest rates usually must rise substantially before the stock market turns down in a major way. Obviously, every cycle is different, as the market response is influenced by a variety of factors, including valuation, the stage of the business cycle and the level from which bond yields begin to increase.

SEI's U.S. large-cap focused portfolios took advantage of the February stock-market dip to equitize excess cash. Cyclical stocks were slightly favored. Exposure to value was increased during the first quarter, since that particular factor looks stretched to the downside relative to momentum and stability. In terms of sectors, financial stocks were overweighted; the sector was appealing to value- and growth-oriented portfolios alike. Low-volatility stocks started to become more attractive after several years of overvaluation, leading to a modest overweight in healthcare and consumer staples. The biggest underweight in SEI's active large-cap portfolios was in technology. Interest-rate sensitive sectors (utilities, telecommunications and real estate) were also underweight, given concerns about rising rates. Energy stocks also remained underweight; valuations were attractive, but there was no momentum.

Our small- and mid-cap portfolios were more defensively positioned. There have been concerns about the relatively high-debt positions of smaller companies, with debt ratios appreciably above the levels prior to the global financial crisis. Valuations were also concerning. Growth and quality appeared expensive. Value stocks looked to be relatively attractive given their material underperformance over the past few years. On the positive side, tax cuts have been a big positive for SEI's small-cap portfolios, since the percentage of firms we held that have no earnings was much smaller than the percentage in the benchmark. The largest sector overweights were in technology, consumer discretionary and industrials. Utilities, real estate, materials and energy tended to be below their benchmark weights.

In fixed income, SEI's core portfolios continued adding duration as bond yields climbed, bringing them neutral or slightly long the benchmark. They still favored credit, with overweight positions in asset-backed securities, commercial mortgage-backed securities and non-agency mortgage-backed securities. In U.S. fixed income, there was an active short-duration bias and portfolios were holding more cash to take advantage of opportunities in the mergers-and-acquisitions credit space. SEI's short-term portfolios had significant holdings in floating-rate debt in anticipation of additional Fed rate increases. In U.S. high yield, our portfolios were short the benchmark's duration; bank-loan exposure increased slightly.

[2] Lori Calvasina and Sara Mahaffey, The RBC Macroscope, RBC Capital Markets, LLC., Feb. 12, 2018, p. 48

Not so Tariff-ic

While we maintain a positive view of equities and other risk assets, we must admit that our optimism is being tested as the Trump administration uses protectionism as a bargaining tool against friend and foe alike. In our view, the imposition of tariffs on any product is harmful in and of itself—it hurts consumers and industrial users of the product much more than it helps the producers. The only good news regarding tariffs: the specific measures on aluminum and steel announced thus far should have a limited impact on economic growth and inflation. Besides, the U.S. administration has been handing out temporary exemptions to its allies, with the notable exception of Japan. South Korea, thus far, is the only country to gain a permanent exemption from the steel tariffs, since it agreed to steel quotas and other measures beneficial to U.S. auto and truck makers. America's North American Free Trade Agreement (NAFTA) partners, Canada and Mexico, are high on the list of countries that export steel and aluminum to the U.S. They were the first two countries to be given temporary reprieves by the Trump administration as encouragement to come to terms on a revised agreement more favorable to U.S. interests.

We are in watchful waiting mode when it comes to trade. The unveiling of tariffs on Chinese goods is concerning, which we will explore more fully below. Even if the World Trade Organization rules against the tariffs imposed by the U.S., we seriously wonder whether President Trump would care. A trade war of consequence could add to the inflation pressures that already are emerging as a result of the pick-up in economic activity and the tightening employment situation.

We think it's premature to expect the worst, however. Until there is more clarity on the extent of the U.S. protectionist measures being put into place, we think it's best to focus on the strong fundamental backdrop. Profits growth remains vibrant, inflation is still well-contained, and Fed decision makers have made clear they'd prefer to normalize monetary policy in a steady, predictable fashion. For now, we favor maintaining a risk-on investment orientation.

The European Theater

We've been disappointed by the poor relative performance of eurozone equities since the middle of last year. It has been our conviction that eurozone shares, as measured by the MSCI EMU (European Economic and Monetary Union) Index (Total Return), would outperform the MSCI USA Index (Total Return).

Our rationale is fivefold:

- First, the eurozone economy has been gaining traction since early 2016; region-wide gross domestic product outpaced U.S. growth in 2017. Investors began to diversify their exposure away from the U.S., as we expected, with fears of deflation and endless austerity in Europe having faded.

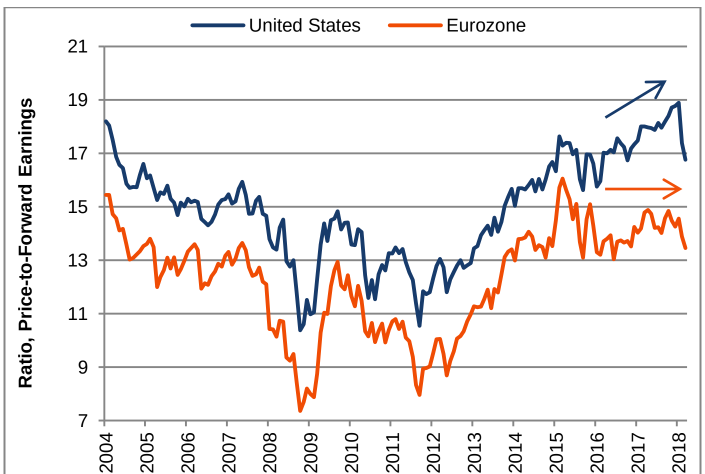
- Second, the potential for future growth was judged to be much greater in the eurozone than in the U.S. since Europe appeared to be in the early stages of its recovery, with labor and capital utilization quite low and monetary policy still extremely accommodative.

- Third, we looked for a decent rise in corporate revenues and an even sharper jump in earnings, given the fact that European companies are saddled with high fixed costs, implying a high degree of operational leverage.

- Fourth, valuation considerations support our bullish rationale. As Exhibit 10 illustrates, the price-to-forward-earnings ratio for the eurozone normally lags that of the U.S. But this discounted value has widened in recent years despite the better economic news coming out of the region.

- Fifth, but not least, there was a political dimension to our pro-eurozone equity rationale. We figured the political turmoil depressing eurozone valuations would subside or, at the very least, not look out of line against the political uncertainty and polarization emanating from the U.S. or the U.K. Obviously, the rise of radical parties and the fading of established centrist ones can pose a problem for both the eurozone and the greater European Union (EU). The recent election in Italy highlights the growing strength of anti-immigrant, anti-EU and anti-monetary union feeling in that country.

Exhibit 10: Europe Still Lags

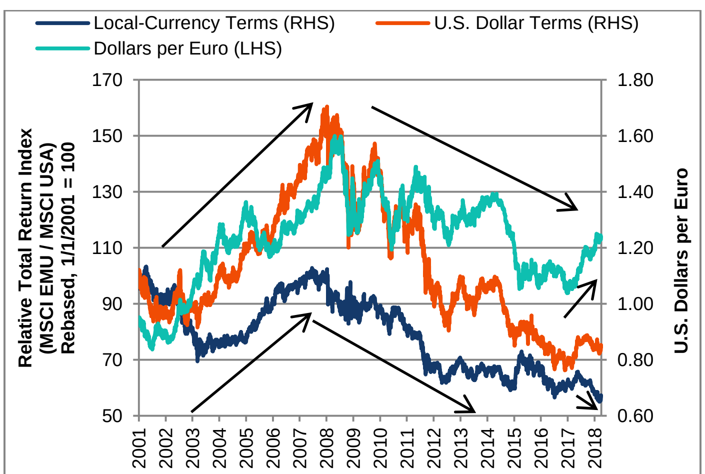


Source: MSCI, SEI

But we've seen progress too. Greece has been off the front pages for the past two years. Spain appears to be settling into an uneasy status quo after the latest election in Catalonia. Germany has finally gotten its grand coalition (although Chancellor Angela Merkel's political power is probably past its peak and the far-right Alternative für Deutschland party continues to gain popularity). France, the eurozone's second biggest economy behind Germany, is making its strongest effort yet to push through labor and social reforms aimed at improving economic flexibility and productivity.

So why has Europe continued to lag? Exhibit 11 shows that the relative performance of the MSCI EMU Index (Total Return) recently touched a new all-time low against the MSCI USA Index, both in local-currency terms. Thanks to a strengthening euro against the U.S. dollar, eurozone equities outperformed on a common-currency basis last year; however, it also can be seen that they have been struggling this year even when the euro's appreciation is taken in to account. Exhibit 11 also shows the euro's ups and downs against the U.S. dollar. For the most part, the euro and the MSCI EMU Index strengthened together, relative to their U.S. counterparts, between 2003 and 2007. During the global financial crises and its immediate aftermath, the euro fell sharply and the MSCI EMU Index (Total Return) declined versus the MSCI USA Index (Total Return). Thereafter, the correlation loosened. Since 2015, the euro has stabilized and recovered, while the relative strength of the eurozone's stock market has continued to weaken. We've been looking for a reemergence of the prior relationship, so far in vain.

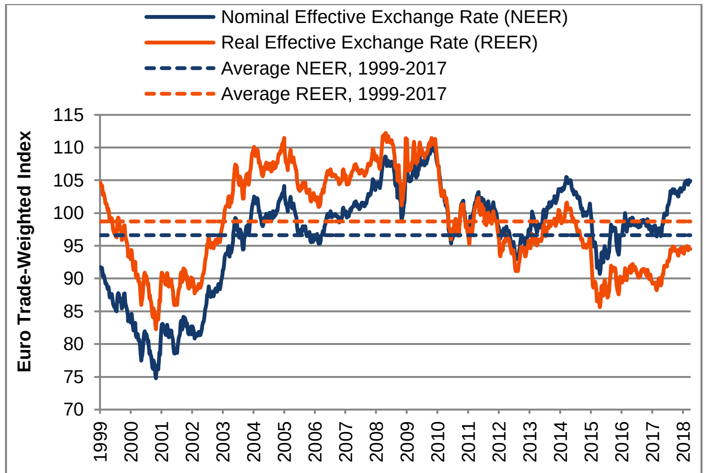
Exhibit 11: A Strong Euro Hasn't Always Been Bad for Eurozone Equities



Source: MSCI, SEI

The euro's appreciation to date has not prevented the region's economic rebound, although it may be tempering earnings expectations: one-year forward consensus earnings growth is estimated at 8.0% versus 18.0% for 2017 and a tax-reform-aided forward earnings-growth estimate of 19.9% for the U.S. According to figures from the Organisation for Economic Co-operation and Development, the euro remains below its purchasing-power parity value against the U.S. dollar. In addition, Exhibit 12 shows that, on a broad trade-weighted basis, the euro's inflation-adjusted exchange rate appears to be only in the middle of its trading range since 2010, and well below its average level recorded between 2003 and 2009. The nominal exchange rate, by contrast, is hovering near its previous cyclical high, and reflects the fact that inflation in the eurozone has been consistently below the domestic inflation rates of most of its trading partners.

Exhibit 12: The Euro May Not be as Expensive As You Think

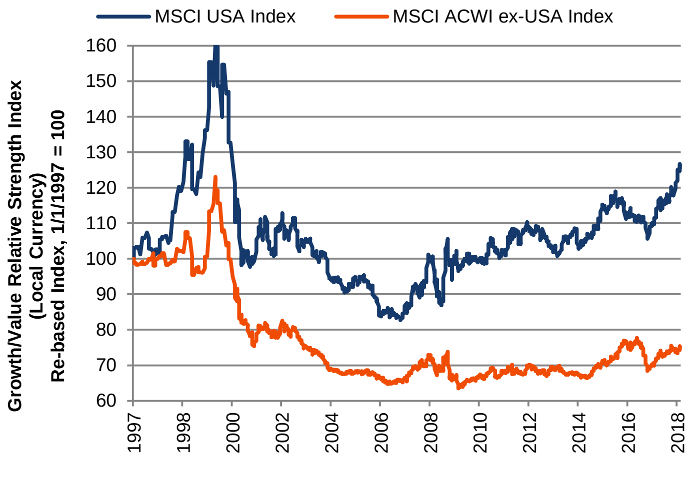


Source: JPMorgan, SEI

We think the most important reason for the muted performance, however, is the composition of the European equity market. The MSCI EMU Index is a value-oriented index whose market capitalization is dominated by financials, industrials and consumer discretionary companies. The MSCI USA Index, by contrast, has an increasingly pronounced orientation toward growth. The technology sector alone accounts for 25.5% of the MSCI USA Index versus just 8.5% in the MSCI EMU Index. Financial stocks, by contrast, make up 21% of the MSCI EMU Index, but less than 15% of the MSCI USA Index. Since technology has been such a strong relative performer in recent years, the U.S. market has been hard to beat. In our opinion, valuations in U.S. technology and in growth areas generally have become somewhat stretched; although we must admit that the technology sector's profits growth has been stellar.

Exhibit 13 shows how growth has walloped value on a relative basis in the U.S., with the run beginning more than 10 years ago. Since last October, the performance divergence has widened dramatically and is reminiscent of what took place during the tech bubble of 1998 to 1999. Outside the U.S., growth stocks have exhibited little tendency to outperform value since 2003.

Exhibit 13: Growth is Made in America



Source: MSCI, SEI

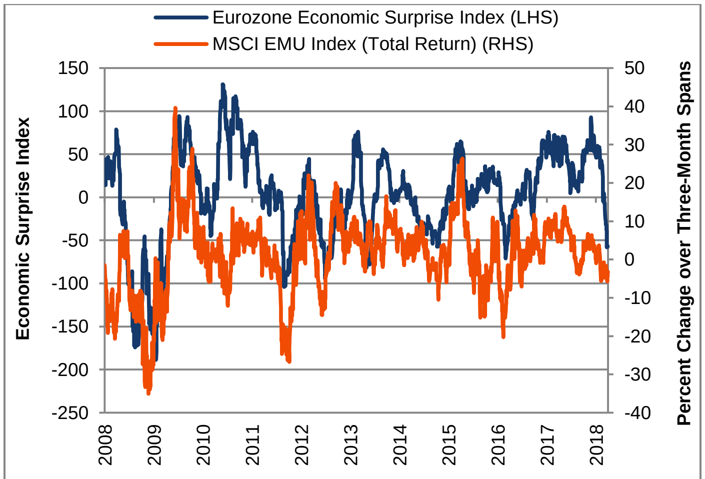
On a fundamental basis, we think investors remain rather skeptical about the staying power of the European expansion. This is especially so as the European Central Bank (ECB) tapers its bond purchases. Whether quantitative easing ends in September or continues for a few additional months is immaterial. The ECB is clearly moving away from supporting the eurozone's economic recovery and credit markets via its asset purchases. And by mid-year 2019, if not sooner, we should see the first steps toward normalizing policy rates—although negative yields are an absurdly low starting point.

Investors in eurozone equities seem to be reacting to the prospect of reduced ECB support in the same fashion that investors in U.S. risk assets did when the Fed tried to wean the economy off quantitative easing in the years following the global financial crisis. The U.S. stock market registered sharp, albeit brief, corrections after the first and second rounds of quantitative easing (known, in turn, as QE1 and QE2) ended in 2010 and 2011, respectively. Stocks wobbled again in mid-2013 when then-Fed Chair Ben Bernanke announced the central bank's intention to taper its bond purchases toward the end of that year. Of course, one cannot blame the U.S. equity market's negative reaction at the time entirely on stop-and-go quantitative easing. Other factors came into play. In 2010, the full dimension of the periphery debt crisis in Europe was just starting to dawn on investors. More generally, the global recovery was still in its early stages; it was feared that there would be an economic relapse as the U.S. central bank withdrew its support. In 2011, the ending of QE2 coincided with a shutdown of the federal government and the debt-ceiling debacle that raised the unthinkable possibility of a technical default by the U.S. Treasury.

Beyond these idiosyncratic factors, there was a definite tendency for stocks to appreciate when the Fed provided liquidity to the financial markets through its bond purchases. When that liquidity source was taken away—or even just the possibility of removal mentioned—stocks hit an air pocket of some consequence.

Europe now looks to be where the U.S. was in the 2010-to-2013 period. The eurozone economy is certainly on sounder economic footing than it was a few years ago, although recent economic data have disappointed investors and traders. Exhibit 14 highlights the Citigroup Economic Surprise Index for the eurozone. The index basically measures macro data outcomes versus Bloomberg's survey of economists' median expectations, and weights those outcomes on the basis of historical reactions in the foreign exchange market. Even though economic growth remains positive, it has failed to keep up with the elevated expectations of market participants. Exhibit 14 also shows that the trajectory of the eurozone reading (often referred to as "the second derivative" of growth) correlates decently well with the three-month percentage change in the MSCI EMU Index (Total Return).

Exhibit 14: The Element of Surprise



Source: Citigroup, MSCI, SEI

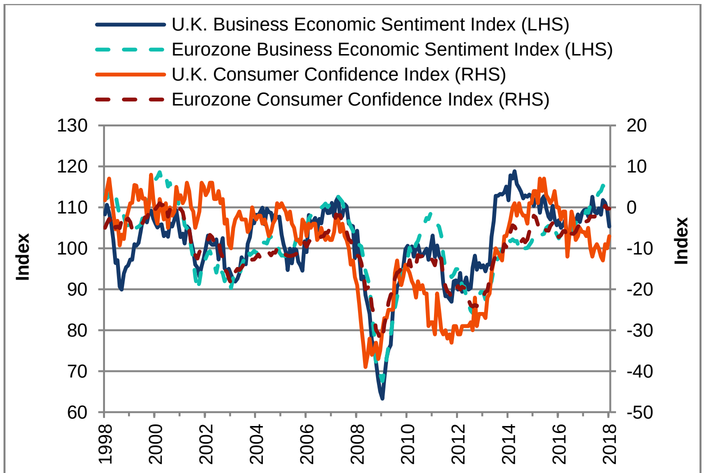
Consumer-price inflation in the eurozone also remains below target, causing many to wonder why the ECB is withdrawing its monetary support at this time. Core inflation is running at a rate of only 1% on a year-over-year basis, well below the ECB's stated target of just below 2%. The Trump administration's threat to engage in a trade war, which would hit Germany the hardest, surely is not helping investor sentiment either. At this point, though, we continue to assume that that the fallout from the Trump administration's aggressive trade stance will be limited, and that the improving global economic picture will enable the ECB to successfully taper its bond purchases without pushing the region back into recession.

U.K.'s Darkest Hour?

While the outlook for the eurozone is quite mixed, it seems bright and sunny compared to that of the U.K—where equities, as measured by the MSCI U.K. Index (Total

Return) in local-currency terms, are down 7.3% in the year to date, versus -2.7% for the MSCI EMU Index (Total Return) and a 0.6% dip for the MSCI USA Index (Total Return). As we have mentioned in previous reports, Brexit has become the overwhelming obsession of investors and policymakers. Exhibit 15 suggests that consumers in the U.K. are particularly perturbed by the divorce. In recent months, a consumer confidence survey by German market research institute GfK has been meandering at its lowest level since 2013, a time when this measure was in the midst of a sharp recovery.

Exhibit 15: That Stiff Upper Lip Begins to Quiver



Source: European Commission, Eurostat, GFK, SEI

Consumer confidence in the eurozone, by contrast, has marched steadily higher since last summer, climbing to its highest level in nearly 18 years. Businesses in the U.K. do not appear quite as glum; their opinion about the future recovered nicely from the shock of the Brexit referendum, although confidence took a hit in March. Notably, businesses in the eurozone are still more optimistic than their U.K. counterparts.

We can understand why U.K. consumers are down in the dumps. Real wages have been eroding as year-over-year consumer-price inflation hovers around 2.7%. Businesses seem to be doing well, owing to the Brexit-related decline in the value of the pound and buoyant demand arising from the global economic recovery. But the uncertainties associated with Brexit are depressing investment in the U.K., and will likely continue to so until there is far more clarity on the country's future relationship with its biggest trading partner. A tentative agreement between Prime Minister May's government and the EU on a transition deal is helpful, but does not make the future trading relationship itself any clearer.

The latest wrinkle in the Brexit saga is the "conversion" of the Labour Party's leader, Jeremy Corbyn, to side of the "Remainers." He now backs a customs union that would keep the U.K. closely tied to the EU. This is a shrewd political move since it capitalizes on the rifts within the Conservative Party as well as on Prime Minister May's currently low popularity. The odds of an early election (one doesn't need to take place until 2022) and a Labour victory, with Corbyn elected as prime minister, are growing. Although a prime minister can be replaced without a general election, the Conservatives do not have a majority in Parliament; they depend on the Democratic Unionist Party, based in Northern Ireland, to remain in power. The Conservatives hold power by the slimmest of threads nowadays; it conceivably could take only a handful of rebels to cause the government to fall.

Of course, as we mentioned in the past, Prime Minister May has managed to hang on precisely because the prospect of a government headed by Corbyn is beyond the pale for most Conservatives and political moderates. If Corbyn manages to gain the keys to 10 Downing Street, we would expect a radical policy shift to the left, both economically and socially. The "Corbynomics" program could include nationalization of the railroads and energy industries, a jump in corporate and personal marginal tax rates, and an end to fiscal austerity, among other dramatic changes. In addition, the country's foreign policy could be upended, given Corbyn's affection for Russia and antipathy toward the U.S. and the North Atlantic Treaty Organization. In our view, a Corbyn government would have nothing to offer investors but blood, toil, tears and sweat.

With regard to positioning, SEI portfolios with an MSCI World ex USA Index mandate remained positively positioned toward Europe, although expectations for absolute performance in the months ahead remain somewhat muted. The earnings picture still appears positive too, with the possibility for additional upgrades as the region's economic recovery deepens. We believe the environment supports more domestically oriented companies, which implies a heavier mid-cap tilt versus larger-cap. There was a distinct tilt toward value, especially in the financial and industrial sectors. Interest-rate-sensitive sectors remained underweighted. Momentum also was favored as a factor, while stability was underweighted. Given the dispersion in performance, some portfolios were shifting funds from the Continent to the U.K. equity market.

Bond portfolios tended to be short duration relative to the benchmark in core markets. The European yield curve remained steep, so curve-flattener strategies were in place. Credit-sensitive assets were preferred versus rate-sensitive sectors. An overweight to Treasury inflation-protected securities and linkers was also a favored strategy.

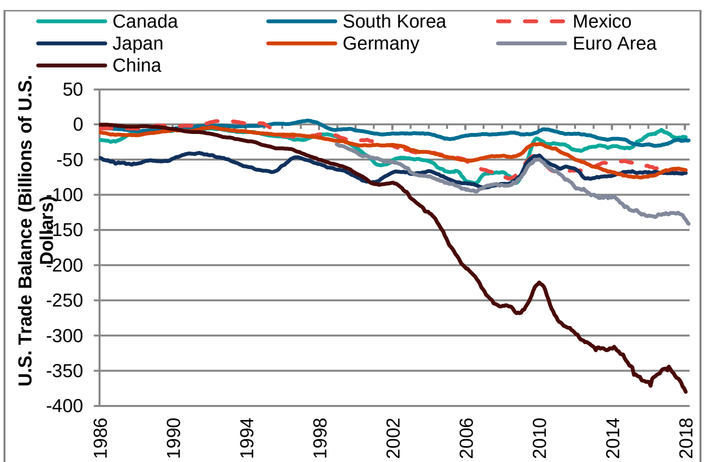
Trade Wars Ahead in Asia?

Ever since Donald Trump's presidential victory in November 2016, we have worried about U.S. trade policy taking a major protectionist turn. For the most part, though, the president's bark during his first year in office was worse than his bite. He did, however, walk away from the Trans-Pacific Partnership and the Paris Agreement on climate change. He challenged Canada and Mexico on NAFTA, but did not pull out of the pact. He threatened to declare China a currency manipulator, but moved off that position as he sought President Xi Jinping's cooperation in an effort to isolate and punish North Korea for its nuclear activities. He also toned down his rhetoric against South Korea and Germany. When General John Kelly was removed from his role as House chief of staff and Steve Bannon let go from his position as advisor, it seemed that the president might be convinced to moderate his long-held views on trade.

That no longer appears to be the case. In January, the Trump administration imposed tariffs on washing machines and solar panels—actions largely directed at South Korea and China, but also hitting other Asian producers, such as Malaysia. Tariffs on aluminum and steel raised the ante a bit more. These measures probably can be likened to a "Phoney War" (where nothing much happens) that precedes a much larger undertaking—the imposition of trade restraints on China. The Trump administration announced on March 22 that it would impose 25% tariffs on up to $50 billion worth of goods (roughly 10% of the total value of Chinese imports into the U.S).

Exhibit 16 compares the trade deficit the U.S. runs versus some of its major trading partners. This is viewed from the perspective of the U.S., which includes Chinese re-exports through Hong Kong. On this basis, China has been the single biggest contributor to the U.S. merchandise trade deficit, by far and away, with the gap recently hitting a new record. The U.S. trade deficit with the euro area has also continued to widen, but is still less than two-fifths of the deficit with China as of February. Excluding Germany, the euro area's trade surplus versus the U.S. was greater than America's trade gap against Mexico at the end of 2017.

Exhibit 16: China Makes, the U.S. Takes



Source: U.S. Census Bureau, SEI

Pick up an introductory economics textbook and you will find that the U.S. president's view on trade is way outside the mainstream, discredited in both theory and practice. Impediments to trade (tariffs, quotas and non-tariff barriers) raise prices and reduce demand, leading to a dead-weight loss for society. More jobs are lost by consuming industries than are gained by the beneficiaries of protection. That being said, there is no denying that those in the U.S. on the losing side of the global trade equation have lost big over the past 30-plus years. The country as whole has benefited, and emerging economies like China certainly have profited, with hundreds of millions of people lifted out of poverty and a subsistence existence. This is scant solace for an American textile, auto or steelworker who lost a high-paying job and was unable to make the transition to another occupation with comparable income and benefits.

Trump was elected because he successfully tapped into the angst and discontent of those areas devastated by the loss of industries and jobs to China, Mexico and other low-cost, emerging economies. While we do not think his protectionist measures will result in some sort of American renaissance in manufacturing employment, his political base still will likely applaud. In fact, Trump's approval rating has been rising steadily since the middle of December, from 37.3% to a current reading of almost 42% as of the end of March, according to the RealClearPolitics[3] website, with his approval rating approaching its highest level since the early months of his presidency.

As is often the case with President Trump's major policy initiatives, it is hard to determine how far he will press his maximalist position on trade against China. What appears to be clear is that the president holds a mercantilist, zero-sum view of international trade: surpluses are good, while deficits are bad. There already has been a crackdown on China's ability to take over certain U.S.-based companies (although it should be noted that the Committee on Foreign Investment in the United States is getting more aggressive on all transactions potentially involving sensitive technology transfers or national-security concerns). In addition, we believe the Trump administration has a legitimate criticism in the way China engages in unfair trading practices in areas like intellectual property and the forced transfer of technology from foreign companies that do business in China.

China will not be the only country hurt by U.S. protectionist actions. Its supplier countries will likely feel the blowback as well. As illustrated in Exhibit 17, South Korea, Japan and Taiwan account for one-quarter of China's total imports, as of February 28, 2018. By comparison, the U.S. makes up less than 8% of China's merchandise imports,

[3] https://www.realclearpolitics.com/epolls/other/president_trump_job_approval-6179.html

while all of Europe accounts for 18.6%. Australia and Brazil combined account for another 8%.

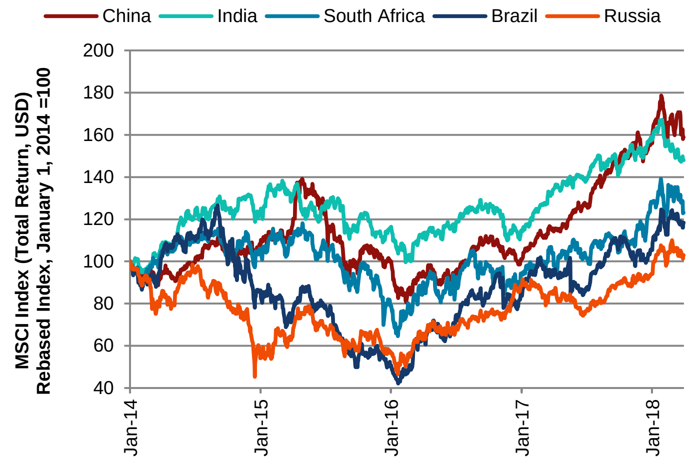
Exhibit 17: Chinese Imports are Important Too

Source: Ned Davis Research, SEI

In addition to the disruption of global supply chains emanating from a trade war with China, imports into China could be further constrained if domestic demand slows on tighter fiscal and monetary policies. Now that President Xi Jinping has consolidated his power and can rule China for as long as he pleases, there is less need to ensure that the country grows rapidly at the expense of exacerbating imbalances such as real-estate speculation, excess debt creation and the expansion of the shadow banking system. That said, February data suggest the Chinese economy kept up its momentum into the Lunar New Year. On the other hand, consumer prices have popped higher and interest rates are appreciably above year-ago levels at the end of March. We also would note that equity prices, as measured by the MSCI China Index (Total Return), have handily outpaced the MSCI ACWI Index in local-currency terms for the past two years.

When viewed together, the BRICS (Brazil, Russia, India and South Africa) in Exhibit 18, it's clear that all are correlated to some extent. India tends to be the least volatile, while the other three commodity-rich countries dance to China's tune more closely. Since the bottom in oil and metals commodity prices during the January-to-February 2016 period, Brazil's equity market in total-return terms has climbed by more than 180% in U.S. dollar terms through the end of March. Russian stocks have appreciated almost 120%, while China and South Africa have seen a near-doubling in their MSCI benchmarks. India has lagged, with a gain of less than 50% as of the end of March, with investors responding to internal developments such as the demonetization shock in November 2016 and the tax reforms instituted in the middle of last year. Additionally, India is a more closed economy than the others and is therefore less affected by the cyclical ups and downs of world trade.

Exhibit 18: A Bull Market Built Out of BRICS



Source: MSCI, SEI

In the event of a serious trade war and China slowdown, we would likely see the reversal of several trends. Resource-oriented emerging markets would lose ground as commodity prices sag. The 2014-to-2015 period was a tough one for the big emerging markets. Russia and Brazil were particularly weak—afflicted not just by China-related volatility and commodity-price weakness, but also by home-grown problems. On the other hand, India's stock market held up well, underscoring its attraction as a lower-beta, safe-haven play. The next few months could be pivotal for global markets, Asia especially.

SEI's emerging-market portfolios were positioned to look past the current trade tensions and maintained a risk-on stance. During the sell-off in February, weights to technology names increased (mostly in Asia). Asia remained underweight as a region, however, mostly to avoid Chinese and Taiwanese banks. Latin America was overweight, with retailers in the region favored as they have benefitted from improving macroeconomic conditions. Cyclical companies such as steel and commodity-related investments remained attractive—as did technology, which stands to benefit from idiosyncratic opportunities and structural growth trends such as rising internet usage. Industrial stocks were favored on the back of strong global growth.

Our emerging-market debt portfolios also remained positioned for a positive outlook. Fundamentals were still solid, thanks to the synchronized global expansion and country-specific reforms that have led to broad improvement in many countries' current-account balances and stronger foreign-currency reserve positions. Although our portfolios are short their duration benchmark in anticipation of higher interest rates, their holdings are biased toward local- over hard-currency (external) debt. Argentina had a meaningful overweight in our portfolios as economic reforms continued to be introduced. Our portfolios also held Czech local-currency debt, drawn by attractive yields. Meanwhile, South African political risk diminished as new leadership provided a market-friendly backdrop. Venezuela debt was also overweight since it trades 20 to 30 cents on the U.S. dollar, but with anticipated recovery potential around 40 cents. Underweights included Philippine and Romanian debt, which offer relatively low yields

It is Always Wise to Look Ahead, but Difficult to Look Further than You Can See

We have focused a lot on the challenges facing global equities. While improvement in the global economy is certainly a good thing, it also means that central banks must begin to move away from the easy policy settings that made sense when growth was weak and the threat of deflation was a legitimate concern. As interest rates rise, equity valuations eventually will come under pressure. The absolute level of interest rates is still very low, however. As mentioned above, we think the bull market in U.S. equities certainly can be sustained until bond yields reach 4% or more.

The greater danger in the near-term is a potential policy mistake on trade. This has been on our radar screen since Trump was elected president. However, we would caution against getting overly pessimistic at this juncture. We prefer to see what trade sanctions are actually levied against China and how China responds, instead of assuming the worst from the get-go.

Another area of political concern is the electoral cycle. Italy still has the potential to depress European equity markets if the populist 5 Star Movement and regionalist Lega (formerly Lega Nord, or the Northern League) parties manage to cobble together a coalition government. At best, this would cause the usual kind of Italian political dysfunction; at worst, it could lead to additional worries about the solvency of the country and its commitment to the euro and the European project. The Brexit saga is also sure to continue in the months ahead, with pessimism over the outcome ebbing and flowing ahead of each discussion.

In the U.S., congressional elections will take place in November. Recent special elections, survey polling and a high-profile redistricting in Pennsylvania put Republican control of the House of Representatives in jeopardy. Mid-term elections often see the party in power lose seats—but this year’s cycle could be a wave election for the Democrats, just as 2010 and 2014 were for Republicans when President Barack Obama occupied the White House. Legislating in the U.S. has been tough enough under a “unified” government of Republican control; it will become next to impossible under split governance, with power more evenly distributed across the two major parties. We would also expect a Democratic House to ramp up the pace of investigations into the president, his staff and Cabinet.

The past nine years have been full of challenges and uncertainties. The years ahead don’t seem to promise anything different in that regard. Yet, the bull market has managed through it all. Let’s give it the benefit of the doubt for a while longer. As Winston Churchill once said, “If you’re going through hell, keep going.”

Glossary

Carry trade refers to a trade in which an investor takes advantage of the interest-rate difference between countries, borrowing from the country with lower rates and investing in the country with higher rates.

Cyclical sectors, industries or stocks are those whose performance is closely tied to the economic environment and business cycle. Cyclical sectors tend to benefit when the economy is expanding.

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.

Option-Adjusted Spreads estimate the difference in yield between a security or collection of securities and comparable Treasurys after removing the effects of any special features, such as provisions that allow an issuer to call a security before maturity.

P/E ratio: The price-to-earnings ratio (P/E ratio) of a stock is equal to its market capitalization divided by its after-tax earnings. The higher the P/E ratio, the more the market is willing to pay for each dollar of annual earnings.

Purchasing power parity is the economic theory that exchange rates between currencies are in equilibrium when their purchasing power is equal in each country.

Spread is the additional yield, usually expressed in basis points (one basis point is 0.01%), that an index or security offers relative to a comparable duration index or security (the latter is often a risk-free credit, such as sovereign government debt). A spread sector generally includes non-government sectors in which investors demand additional yield above government bonds for assumed increased risk.

Index Definitions

CBOE Volatility Index (VIX): The VIX, or Chicago Board Options Exchange Volatility Index, uses option prices on the S&P 500 Index to estimate the implied volatility of the S&P 500 Index over the next 30 days. Options are derivative contracts that give a buyer the right (and impose upon the seller an obligation, if called upon by the buyer) to buy or sell an underlying security at a specified price, usually for a specified period of time. A higher number indicates greater volatility; an increase in the VIX is often associated with higher risk aversion among investors. Common usage: The Chicago Board Options Exchange Volatility Index (VIX), a barometer of market volatility.

Citigroup Economic Surprise Index (CESI): The Citigroup Economic Surprise Indexes (CESI) are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases versus Bloomberg Barclays survey median). A positive reading of the CESI suggests that economic releases have, on balance, been beating consensus. The indexes are calculated daily in a rolling three-month window. The weights of economic indicators are derived from relative high-frequency spot FX impacts of 1 standard deviation data surprises. The indexes also employ a time decay function to replicate the limited memory of markets.

Consumer Price Index (CPI): The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

MSCI ACWI ex USA Index: The MSCI ACWI ex USA Index includes both developed- and emerging-market countries, excluding the U.S.

MSCI China Index: The MSCI China Index captures large- and mid-cap representation across China H and B shares, Red chips, P chips, and foreign listings (such as ADRs). With 151 constituents, the Index covers about 85% of this China equity universe.

MSCI EMU Index: The MSCI EMU Index (European Economic and Monetary Union) captures large- and mid-cap representation across the 10 developed-market countries in the European monetary union (EMU). With 247 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization of the EMU.

MSCI Total Return Indexes: The MSCI Total Return Indexes measure the price performance of markets with the income from constituent dividend payments. The MSCI Daily Total Return (DTR) methodology reinvests an index constituent's dividends at the close of trading on the day the security is quoted ex-dividend (the ex-date).

MSCI United Kingdom Index: The MSCI United Kingdom Index is designed to measure the performance of the large- and mid-cap segments of the U.K. market. With 102 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in the U.K.

MSCI USA Index: The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the U.S. market. With 632 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in the U.S.

MSCI World Index: The MSCI World Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity-market performance of developed markets. The MSCI World Index consists of 24 developed-market country indexes.

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

St. Louis Fed Financial Stress Index: The St. Louis Fed Financial Stress Index measures the degree of financial stress in the markets and is constructed from 18 weekly data series: seven interest-rate series, six yield spreads and five other indicators. Each of these variables captures some aspect of financial stress. Accordingly, as the level of financial stress in the economy changes, the data series are likely to move together.