Climbing a Big, Beautiful Wall of Worry

Economic Outlook

First Quarter 2017

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- The first months of the Trump Presidency have been filled with varying amounts of confusion and controversy.
- Despite political challenges, domestic and European equities continued to move higher for most of the quarter.
- While U.S. equity valuations are a moderate concern, low interest rate and a strong economy remain supportive.

"But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade? And how do we factor that assessment into monetary policy?" – Alan Greenspan, former U.S. Federal Reserve Chairman, December 5, 1996

"I hope I'm wrong, but I think we're in a big, fat, juicy bubble." – U.S. presidential candidate Donald Trump on CNBC's "Power Lunch," February 8, 2016

Political affiliations aside, there is simply no way to address the current state of the economy and financial markets without acknowledgement that the first months of the Trump presidency have turned out much like the Trump presidential campaign: with nearly every day filled with varying amounts of confusion and controversy. The new administration has been dogged by several challenges, including nationwide protests over women's rights, healthcare and immigration; delays caused by Democratic senators in the confirmation of Cabinet appointees; shocking tweets by the president accusing his predecessor and British intelligence officials of illegal "wiretapping;" and an embarrassing defeat of healthcare reform at the hands of his own party. Clearly, the November elections have done nothing to heal the political fissures that exist in the country; on the contrary, the divide has only deepened.

There's no denying that the administration's agenda has gotten off to a slow start. Some of this can be blamed on tactics of the opposition party during the confirmation hearings that have prevented key Cabinet and sub-Cabinet personnel from assuming their positions. But internal divisions among Republicans in Congress over healthcare and tax reform haven't helped. Granted, the agenda itself is controversial, far-reaching and highly complex. With the stakes so high and the partisan divide so deep, the sausage-making that is part and parcel of the legislative process is unusually gruesome to watch.

Although slow and painful, the process will grind on. For example: despite the inability of the Republican House to pass the version of healthcare reform championed by House Speaker Paul Ryan and backed by the White House, Republicans will continue to seek a repeal-and-replace alternative. If nothing is done to shore up the program, insurers are expected to continue pulling out of counties and states in which they are losing money. The result will likely be spiraling government expenditures to cover lower-income recipients. Higher-income individuals and families, meanwhile, will face rising premiums, deductibles and co-payments for medical services. If Health and Human Services Secretary Tom Price uses his legal authority to waive the penalty for not buying insurance, the private healthcare exchanges where consumers purchase coverage are likely to collapse within a couple of years.

Some of the savings envisioned in the proposed Republican healthcare bill would have made it easier to pursue the deep corporate and individual tax cuts that are expected in the fiscal-year 2018 budget resolution. If those savings are not achieved, the cuts will need to be more modest in scope. That scope will be further constrained if the controversial border-adjustment tax proposal, which would tax imports and provide rebates to exports, is jettisoned.

One might think that U.S. equities would have stumbled badly in reaction to the Trump administration's rocky start and the possible watering down and delay of tax reform. While U.S. equities have slightly lagged the rest of the world since the election, as measured by the MSCI All-Country World ex-USA Index (Total Return) in both dollar and local-currency terms, the results remain impressive. As seen in Exhibit 1, the MSCI USA Index (Total Return) has advanced about 6% since the end of last year, and is only 1% below its closing high reached on March 1. Since the day after the election on November 10, the Index has logged a total return of 10%.

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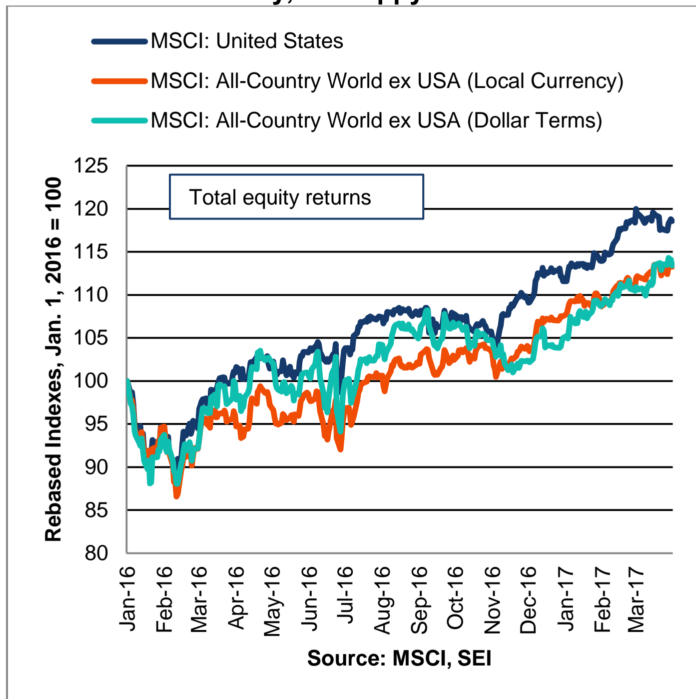
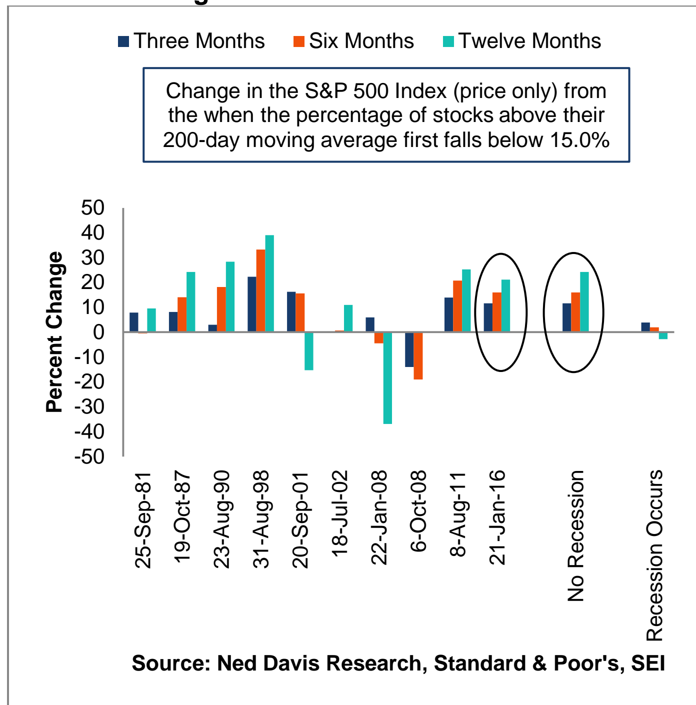
Exhibit 1: Don't Worry, Be Happy



Source: MSCI, SEI

Exhibit 2: Being Bullish When Others Are Bearish



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

We note that most stock-market pundits have badly underestimated the rally in share prices this year. The S&P 500 Index price level, for example, has already reached or exceeded the typical end-of-2017 predictions cast at the start of the year. Not surprisingly, the inclination today is to downplay the potential for further stock-price appreciation. After all, skepticism and outright pessimism have been the hallmarks of this bull market since it began eight years ago. Indeed, it was just over one year ago when the talking heads on CNBC and Bloomberg were warning of poor equity-market performance for 2016 as a whole — to be driven by declining U.S. earnings, deflationary pressures in Europe and Japan, collapsing oil and commodity pricing, excessive Chinese debt and a generally weak global economy.

At that time, we leaned against the prevailing bearishness, noting that the selling pressure in equities had hit an extreme in January 2016 — the kind that typically leads to a sharp rally over the next three, six and twelve months. In Exhibit 2, we updated the chart we used last year to underscore this point, showing the resultant rally through 2016 and into early 2017. The chart itself measures the price-only performance of the S&P 500 Index from the time the percentage of stocks trading above their 200-day moving average initially falls below 15%. The sharper and more prolonged the stock correction, the lower the percentage of stocks still trading above their 200-day moving average.

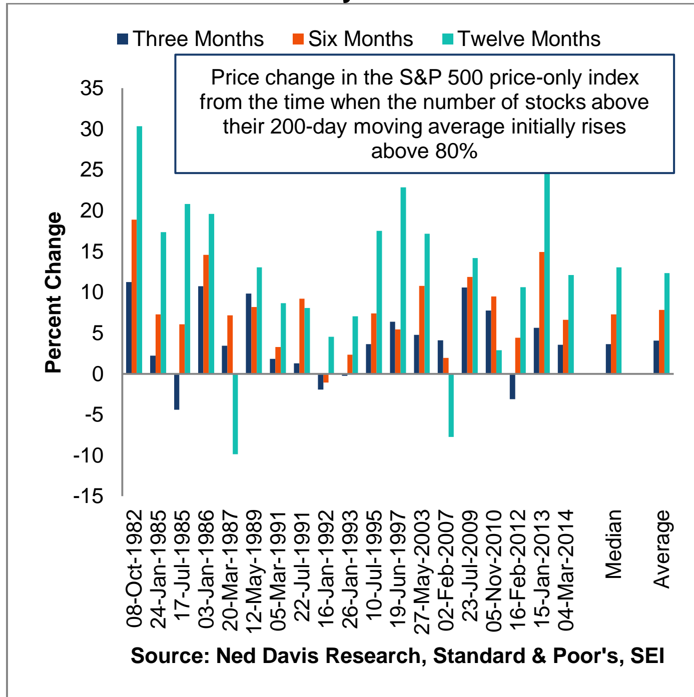
On January 21, 2016, less than 15% of multi-capitalization stocks were trading above their 200-day moving average, according to Ned Davis Research. Three months later, the S&P 500 Index (price only) had climbed 11.7%. Six months later, the gain amounted to 16.0%. Twelve months later, on January 21, 2017, the appreciation in price totaled 21.2%. The price appreciation over all three time frames closely matched the median performance for all three periods over the previous 36 years when stocks were oversold but an economic recession was avoided.

Today, the economic and stock-market backdrop is considerably different. The percentage of stocks trading above their 200-day moving average is approaching 80%. Is that a sign of a frothy and overbought market — a "big, fat, juicy bubble," in Donald Trump's words? Will U.S. equities struggle over the next three, six and twelve months, as the consensus of market forecasters suggest? If history is any guide, the answer is an emphatic "no." In the past 36 years, we have seen almost 20 occasions when the percentage of stocks trading above their 200-day moving average exceeded 80%. Most of the time, the bull market in equities has continued on its merry way.

Exhibit 3 also examines the price-only performance of the S&P 500 Index over three-, six- and twelve-month timeframes — this time measuring performance from the time the percentage of multi-capitalization stocks trading above their 200-day moving average first surpasses 80%. The limited number of negative outcomes is striking. That's because bull markets tend to roll over into bear markets gradually. In contrast, corrections/bear markets and their subsequent recoveries often are V-shaped affairs, with deep declines followed by rapid recoveries. Over the 19

occasions that the 200-day moving average initially breached 80% to the upside, equity prices have declined only twice in each subsequent 12-month period. Those two occasions included the 1987 and 2007-to-2009 bear markets. Across all occasions, the median and average price-only performance for the following 12 months was 13% and 12%, respectively.

Exhibit 3: Bulls Like to Stay Bullish

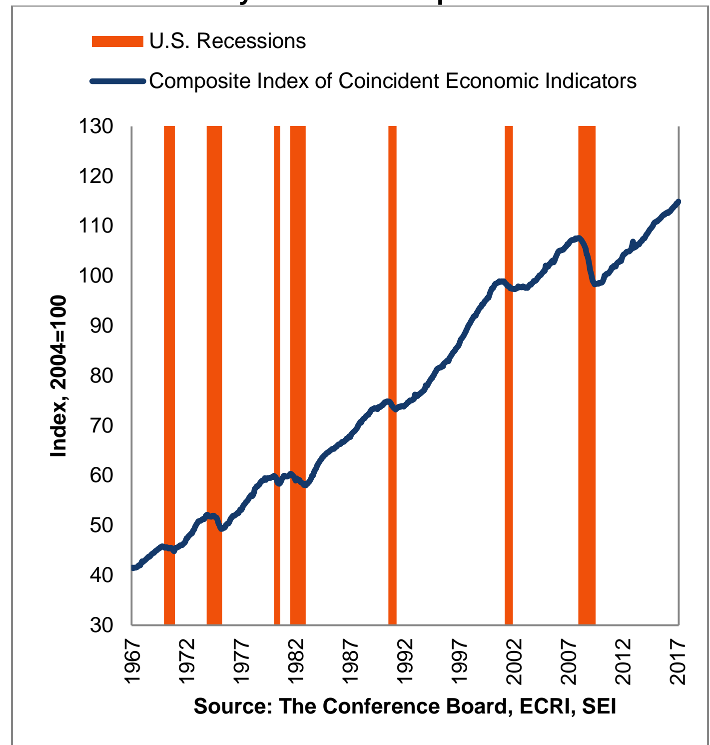


Source: Ned Davis Research, Standard & Poor's, SEI

We acknowledge that there's nothing fundamental about this analysis. It doesn't make an assessment of underlying economic conditions, profits trends, direction of U.S. Federal Reserve (Fed) policy or market valuation.

So let's turn our attention to some of those fundamentals. On balance, things are looking pretty good. The Conference Board's composite index serves as a good proxy for the relative health of U.S. business activity. The index includes four widely watched economic indicators: the number of employees on nonagricultural payrolls; personal income less transfer payments; industrial production; and the volume of manufacturing and trade sales. As Exhibit 4 indicates, the index continues to steadily climb, even though the industrial production component has been flat-lining for more than year. There's not much sign of a significant acceleration in the rate of growth; but there is certainly no indication that the economy is losing altitude.

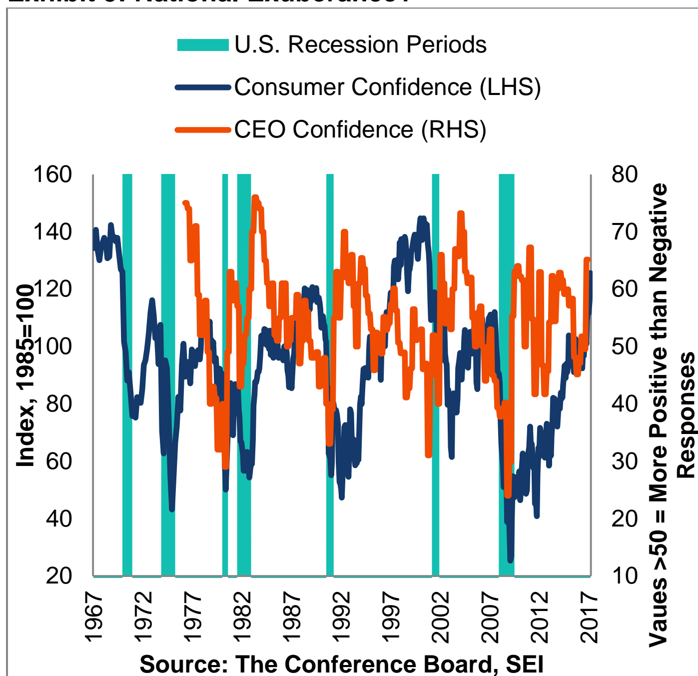
Exhibit 4: A Steady Economic Ship



Source: The Conference Board, ECRI, SEI

Most eye-catching, however, has been the steep rise in confidence, as documented in Exhibit 5. Both business and consumer confidence have surged in the aftermath of the U.S. presidential election on hopes that the Trump administration will push for changes in laws and regulations that will help reduce the costs of doing business, increase household incomes and employment, and enhance the availability of credit. A pessimist would point out that consumer confidence already has reached a level that has often preceded the onset of recession; consumer confidence is always high at the top of the economic cycle. We would counter with the observation that business confidence tends to deteriorate as an expansion ages. By the time a recession begins, CEOs are typically already cautious. Yet that sort of caution is not in evidence at this time.

Exhibit 5: Rational Exuberance?



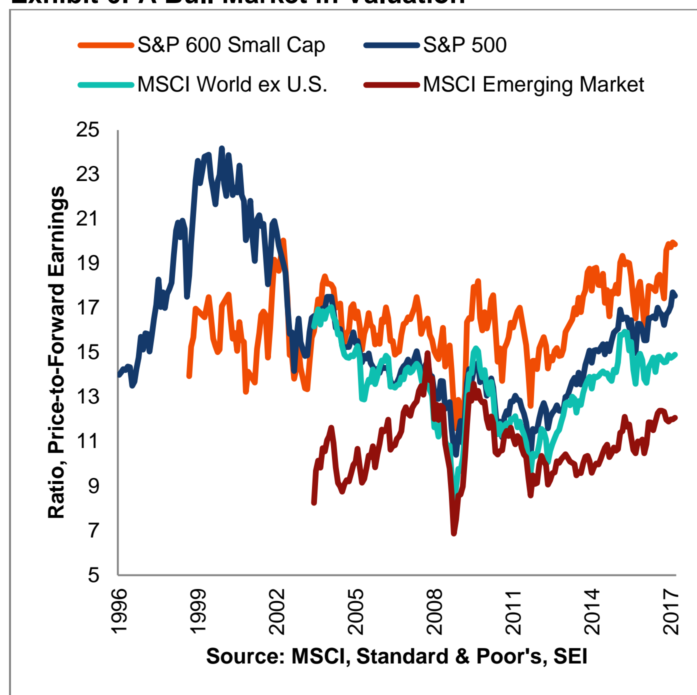
Source: The Conference Board, SEI

Security analysts also have gotten more optimistic; although the undoing of healthcare reform may temper their enthusiasm. Actual earnings per share were still flat-lining during the fourth quarter, but are sure to pick up as energy companies stop reporting big losses (-75% in 2016) and start posting gains from a low base. Consensus estimates for the S&P 500 Index are in the 10% range for 2017 and 12% for 2018. These earnings estimates probably overestimate the impact of corporate tax-rate cuts and the repatriation of cash in 2017, but may underestimate the gain in 2018.

Stock-market investors are also anticipating better times ahead. Forward earnings estimates are rising more rapidly than actual earnings, while multiples on those forward earnings have expanded sharply in recent months. The forward price/earnings ratio on the S&P 500 Index has climbed to 17.6 times, its highest point since 2003 (Exhibit 6). The forward multiple on small-cap stocks is even loftier, at almost 20 times, reaching its highest level in 16 years. By contrast, valuations are considerably more subdued for the MSCI Emerging Markets and MSCI World ex-U.S. Indexes. We agree that the U.S. equity market is less attractive on a valuation basis than it used to be; yet it would be a mistake to discount the momentum that U.S. equities still enjoy, owing to the promise of accelerating revenue and earnings growth.

Nonetheless, one can make a good argument that it's time to fade U.S. equities and tactically overweight global equity markets. That doesn't mean that U.S. equities are dangerously overvalued. To paraphrase former Fed Chairman Alan Greenspan: investors are rationally exuberant at this juncture.

Exhibit 6: A Bull Market in Valuation



Source: MSCI, Standard & Poor's, SEI

SEI's large- and small-capitalization portfolios are more defensively positioned now compared to year-end 2016. Stocks with value characteristics have been trimmed, owing to exceptionally rich valuations and overly optimistic earnings expectations. Those expectations, especially for domestically oriented companies, are fading as it becomes clear that tax reform will likely be a 2018 event as opposed to occurring in the current calendar year. Accordingly, our portfolios have been increasing the weight of companies with sustainable growth characteristics.

The Fed Hasn't Pulled the Punchbowl Away

We have said on many occasions that bull markets do not die of old age — they get murdered. And the killer is the Fed. Although the central bank's rate setters surprised many observers by raising the federal funds rate in March, they are merely on pace to do what they said they would do, namely, increase overnight rates three times in 2017. Rising interest rates can be a problem for stock prices; but it's important to take into consideration their current level and the speed at which they go up. In our opinion, interest rates across the maturity spectrum are still low enough to allow the positive impact of economic growth and improving corporate profitability to translate into higher stock prices.

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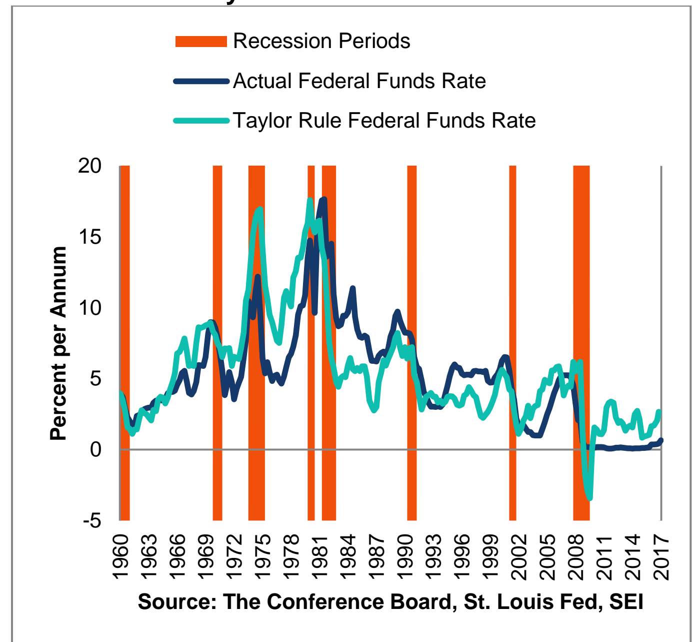
We would become more concerned if the Fed picked up the tightening pace or if the federal funds rate surpasses the rate of inflation. The latest "dot plot," the graphical presentation highlighting the interest-rate expectations of Federal Open Market Committee (FOMC) members over the next three years, suggests this won't happen anytime soon. In any event, we only have a high degree of confidence in the Fed's forecast of its own actions through the rest of 2017. The makeup of the Fed's board of governors will undergo significant changes in the months ahead, as President Trump will have the opportunity to appoint three governors

In addition, Fed Chair Janet Yellen's tenure ends in February 2018. Although her term as a Fed governor ends in 2024, we think it's highly unlikely she will stay if not reappointed as chair by the president. Vice Chair Stanley Fisher's tenure in the number-two position also expires next year, while his term as a governor extends to 2020. It's therefore possible that Trump will have the chance to name five of the seven Fed governors over the next 15 months.

If his Cabinet selections are any indication, Trump could very well opt for nominees with business and banking/finance backgrounds, and shy away from the PhD academics that have come to dominate the board since the mid-1960s. Even if the president continues with tradition, however, we could see academic economists placed on the Board who are less enamored of the discretion employed by the central bank in the conduct of monetary policy. There are some well-respected conservative economists who would prefer a rules-based approach. A follower of the Taylor Rule, for example, might want to normalize rates faster than currently envisioned in the dot plots.

Exhibit 7 is an update to a chart we presented a year ago that uses the Taylor Rule to analyze the federal funds rate. Named after Stanford economist John Taylor, the rule provides some insight into where the federal funds rate "should" be versus where it is. It is based on three factors: actual versus targeted inflation levels; actual employment or output versus an estimate of full-employment levels; and the level of short-term interest rates thought to be consistent with full employment and a steady (non-accelerating) inflation rate. A year ago, this measure suggested that the federal funds rate should have been in the 1.5%-to-1.75% range instead of the 0.25%-to-0.50% range targeted at the time by the FOMC. Since then, inflation has rebounded and the output gap has narrowed further, indicating (based on the Taylor Rule) that the federal funds rate should be near 2.75% compared to the current 0.75%-to-1.00% range that was approved in mid-March. Note that the federal funds rate target suggested by the Taylor Rule is close to the FOMC's forecast of 3% for the long-run equilibrium federal funds rate.

Exhibit 7: Will Taylor Rule?



Let's underscore the fact that no one knows what the makeup of the Board of Governors will be a year from now. Still, we should be prepared for the possibility of a less-dovish Fed to take shape. It might mean that the central bank steps up the pace of its interest-rate increases from the three hikes that are penciled for this year (including the one that occurred in March) and three more next year. But there are too many unknowns at this point to make such predictions with confidence. Market-implied projections of the funds rate still point toward a dovish Fed, pricing in only three total rate hikes between now and the end of 2018, versus the five more penciled in by the FOMC.

From an investment perspective, we still anticipate mildly higher bond yields this year. Our portfolios are positioned for further flattening of the yield curve, while duration is being managed on an opportunistic basis as Treasury bond yields fluctuate in a rather narrow range. Core fixed-income portfolios are overweight spread sectors, especially banks. They are overweight student-loan debt and commercial mortgage-backed securities, but underweight sub-prime autos. U.S. Treasury bonds are still viewed as a relative value play versus low-yielding global bonds. In general, positioning is neutral between investment-grade credit and government sovereign debt, given the tightening of the credit spread to its narrowest point in two years. In the high-yield space, caution is warranted following last year's exceptionally strong performance. Accordingly, duration is underweight and credit quality is in line with the benchmark. Bank loans and cash holdings have ticked higher. For the most part, we see the high-yield market as fairly valued.

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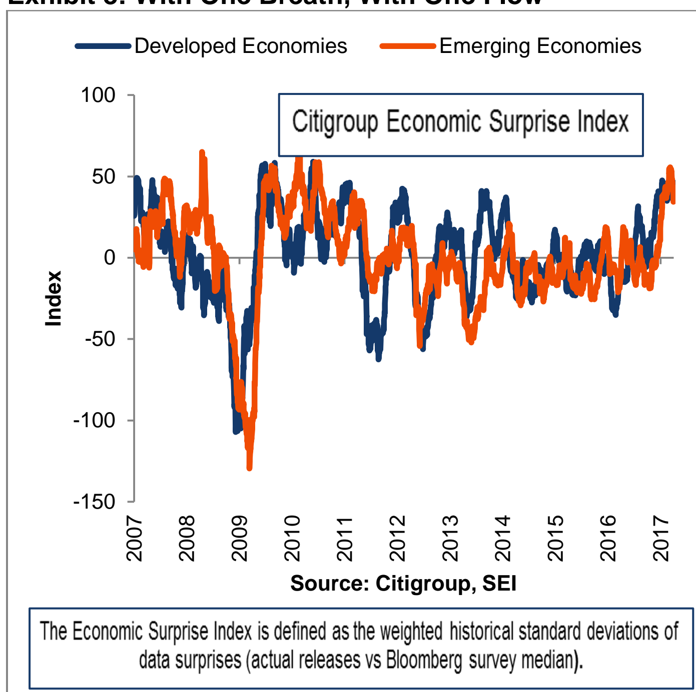
Signs of Synchronicity

At the beginning of the year, we noted that economic growth in Europe was surprising to the upside. The data are still unexpectedly moving in that direction. Indeed, we are witnessing the strongest synchronized move higher in the economic data across developed and emerging economies since the 2009-to-2010 period (Exhibit 8). As in the U.S., the improvement is more notable in the "soft" economic data (surveys of purchasing managers, business sentiment and consumer confidence, for example) than in the "hard" data (such as retail sales, construction and industrial production). As a major exporting region, this synchronized improvement in global activity is good news for the European outlook.

Exhibit 8: With One Breath, With One Flow



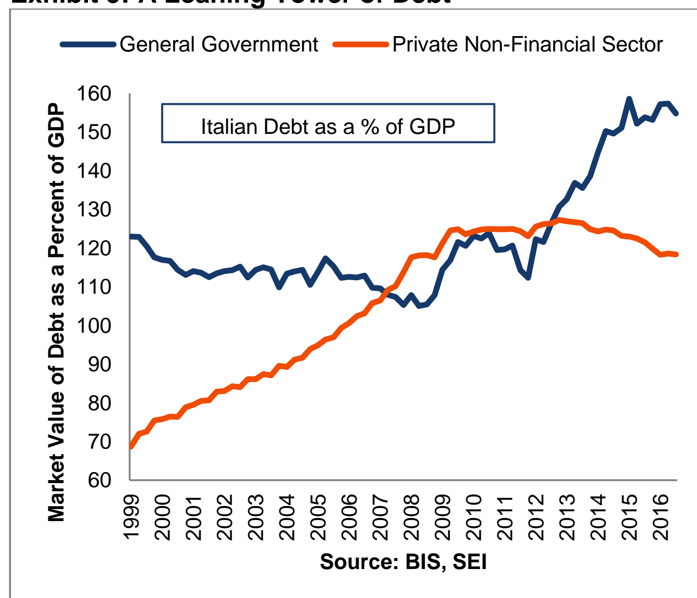
We maintain the view that the European Central Bank (ECB) will be slow to ease off the gas pedal, despite all the talk of tapering its bond buying. There might be green shoots of recovery, but we view those shoots as fragile. The ECB does not want to repeat the mistake it made in 2011, when it prematurely hiked interest rates two times, only to beat a hasty retreat when the debt crisis of the peripheral eurozone took a dramatic turn for the worse. The ECB will likely eliminate its bond buying before raising interest rates.

Political considerations also may weigh heavily in the ECB's calculations. Although the prospect of a Trump-like populist uprising has receded since the start of the year, sluggish economic expansion and weak wage growth could stoke another flare-up in voter dissatisfaction. Anti-euro and anti-European Union (EU) sentiment has been dampened, but not extinguished. Investors remain nervous about Europe's periphery. Italian government-bond yields, for example, remain near their highest level over the past two years in absolute terms and at a three-year high relative to German bunds.

In France, the scandal that has engulfed presidential candidate (and former prime minister) Francois Fillon has opened a path to victory for independent-candidate Emmanuel Macron. Three months ago, we wondered how well Fillon's hardline economic reforms would play among the electorate. The economic reform proposals set forth by Macron seem less extreme and more in keeping with the sensibilities of the average French voter. It may not be the root-and-branch reform the economy needs, but even a modest program toward a more business-friendly environment and flexible labor market would represent a step in the right direction. Most importantly, the threat of an upset victory by Marine LePen of the National Front now appears much reduced.

The promise of better economic performance, an easing of political concerns and the relatively low valuation of European equities versus those of the U.S. have made us more favorably disposed toward eurozone equities on a tactical basis. We still harbor concerns about Italy, however. Although progress is being made in recapitalizing its banking system and writing off bad debt, a multi-year process will take place before Italy is on sounder footing. Exhibit 9 shows the market value of Italian government and private, domestic non-financial debt as a percentage of gross domestic product (GDP). The debt burden of private, non-financial debt has eased from a peak of 127% in 2013 to 118% as of last year's third quarter. However, the market value of general government debt has continued to climb, reaching 155% of GDP. This is an unsustainable trajectory, in our opinion.

Exhibit 9: A Leaning Tower of Debt



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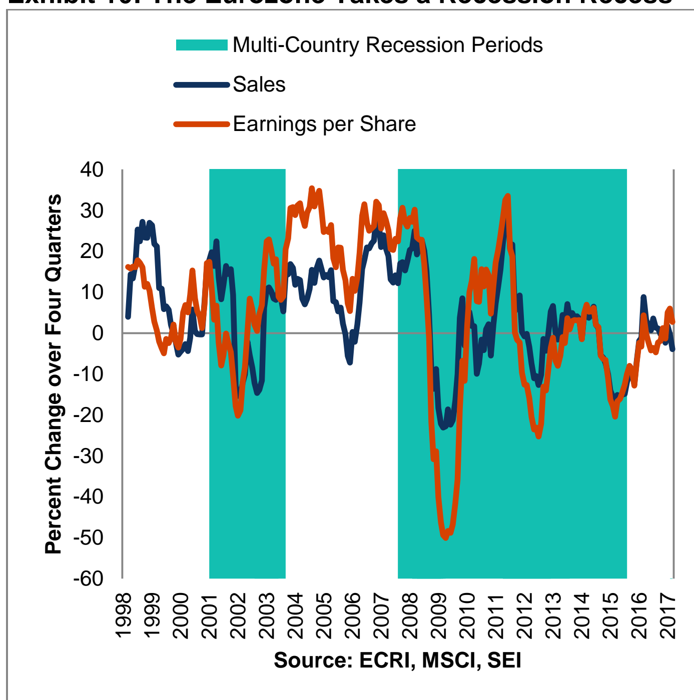
We don't foresee Italy being able to grow out of its problem. The continuing debt overhang will serve to constrain the flow of credit to the private sector. Its government will have no choice but to pursue further austerity. Meanwhile, the sclerotic labor and product markets along with a dysfunctional political and judicial system will make it even harder to compete within the straitjacket of the euro-currency framework. We are assuming that Italy will not leave the eurozone anytime soon. Nor do we expect that the more radical solutions endorsed by the 5 Star Movement will see the light of day. But if there is a weak link in what appears to be an improving European economic trend, it is surely Italy.

In the meantime, the modest pickup in eurozone growth has helped push the year-over year change in earnings into positive territory, as detailed in Exhibit 10. Europe's companies are saddled with high fixed costs. Earnings therefore tend to drop more sharply during economic slowdowns, but rebound more sharply during upturns versus the up-and-down cycles in the U.S. and other developed countries and regions. If the global economy is indeed getting traction, European companies should benefit more than most as a result of this operational leverage.

Exhibit 10: The Eurozone Takes a Recession Recess



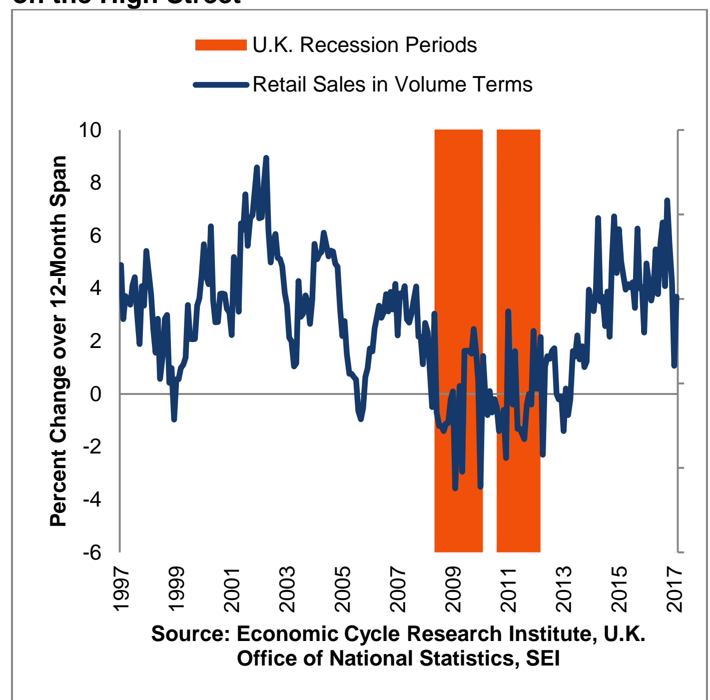
Source: ECRI, MSCI, SEI

The Battle of Brexit Begins

In his excellent book, *The Sleepwalkers: How Europe Went to War in 1914*, Christopher Clark wrote, "On both sides they imagined that 'bluffing' would suffice to achieve success. None of the players thought that it would be necessary to go all the way. The tragic poker game had begun." To be sure, even the worst possible outcome of Brexit could never compare to the catastrophe of The Great War. Still, we thought of this passage as U.K. Prime Minister Teresa May invoked Article 50 on March 29, thereby starting the clock to the United Kingdom's exit from the EU.

When the Brexit referendum occurred last June, we figured the sharp decline in sterling would cushion any negative economic reaction resulting from the uncertainty. Like many other observers, we have been surprised at how well the economy has performed. U.K. inflation-adjusted GDP rose 2% last year, mostly in line with other major developed countries. Household consumption was surprisingly buoyant; although there are increasing concerns that incomes are starting to lag in real terms, as inflation picks up as a result of the currency depreciation. Retail sales have turned notably weaker over the past couple of months (Exhibit 11). Consumer prices are swinging higher on energy, much like in other countries. However, core inflation also continues to accelerate (albeit at a mild pace), approaching 2% on a year-over-year basis. Despite this rise, the Bank of England had held its base rate steady, following a 50 basis-point cut in the aftermath of the Brexit vote.

Exhibit 11: Spending a Tad Lower Lately on the High Street



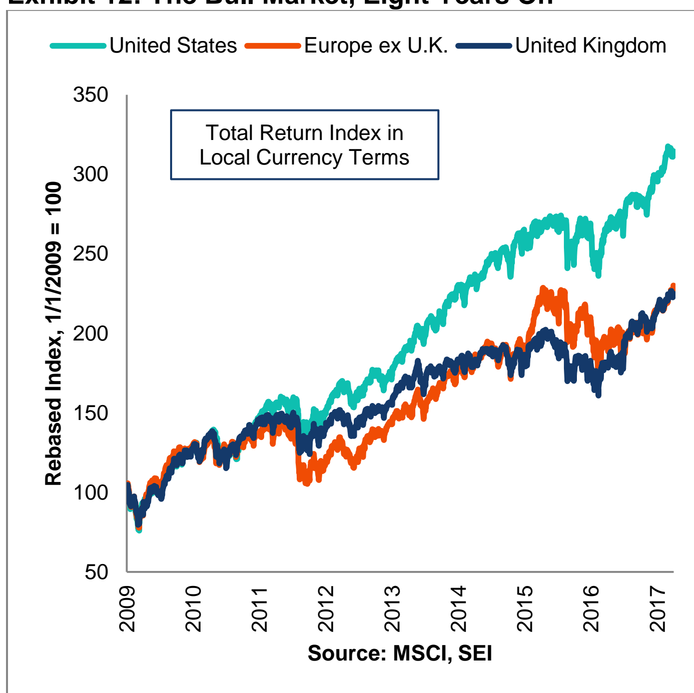
Source: Economic Cycle Research Institute, U.K. Office of National Statistics, SEI

Although inflation pressures seem to be building, it doesn't look as if the Bank of England is in a rush to tighten policy. The uncertainties surrounding Brexit simply are too great. This poker game begins with all the players in an ugly mood. Hopes for a soft Brexit have faded in recent months, as the government of Teresa May seeks severe limits on the free movement of people from the EU and takes back sovereignty from the European Court of

Justice. The EU, meanwhile, wants to impose an exit fee of up to €60 billion even before substantive discussions begin. This huge sum reflects an estimate of the net liabilities owed by the U.K. for spending commitments the EU has made that would benefit the U.K., and for the cost of staff pensions in EU institutions. It is a bad start to a challenging process that could leave City of London banks without "passporting rights" (that is, the right to offer financial services to the rest of the European Economic Area); impose higher tariffs on farmers and goods manufacturers; and leave many service-producing industries not covered by World Trade Organization rules at a severe competitive disadvantage.

Since the Brexit vote last June, the U.K. stock market, as measured by the MSCI United Kingdom Index (Total Return), has outperformed the rest of Europe on a local-currency basis — but has underperformed from the perspective of a U.K. investor in sterling terms, owing to the pound's sharp depreciation against the euro and other European currencies. With that noted, a 24% appreciation since the day of the vote is a stunning performance. Exhibit 12 reveals that, since the beginning of 2009, the U.K. and the rest of Europe have logged a cumulative gain of 125% in local-currency terms. This total-return performance badly lags the 210% cumulative appreciation achieved by U.S. equities.

Exhibit 12: The Bull Market, Eight Years On



There remains little clarity regarding Brexit. Will it be hard or soft? Will there be a long adjustment period after an agreement is reached, or will the U.K. see a jarring exit out of the eurozone at the end of two years? Will financial companies be forced to abandon London and set up their headquarters or transfer their staff *en masse* within the borders of the EU in order to benefit from preferential trade treatment? It's too early to tell — which is why investors seem to be ignoring the issue and instead concentrating on more favorable economic data. If the worst comes to pass, however, the U.K. will not only sleepwalk into a less-optimal trading position; it may also be forced to deal with another referendum on Scottish independence. We see little upside in any of this.

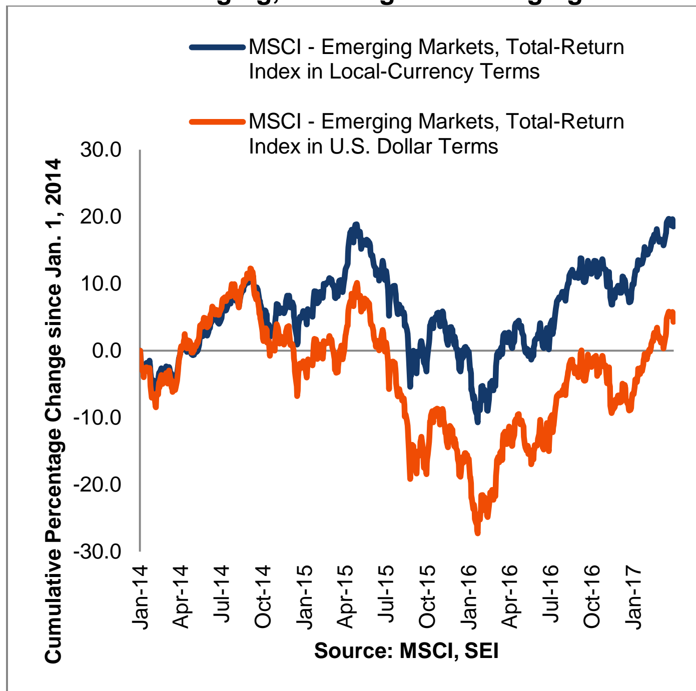
Our global equity portfolios are focusing on the relative value of Europe versus the U.S. market. We are heartened by the positive signs of macroeconomic improvement. Profits growth has been better in the U.K. than on the Continent as a result of currency patterns; but the earnings outlook for Europe is improving. Our portfolios are overweight value sectors (industrials, consumer discretionary, financials) and underweight stability sectors (consumer staples and healthcare). This positioning is similar to where it was at the end of last year.

Like our global equity portfolios, our fixed-income positioning has not changed much since the end of 2016. The overweight to credit has been reduced, and there is a preference for U.S. investment-grade paper relative to European investment-grade securities. Financials are favored over industrials on a sector basis. Australian sovereign debt also appears attractive, with 10-year government bonds trading near 2.8% at a time when economic data in that country are turning somewhat softer. Managers remain overweight the U.S. dollar against the euro and the Japanese yen. Global fixed-income portfolios are slightly underweight the benchmark's duration. Inflation protection still offers reasonable value, despite the backup in breakeven rates.

Emerging Markets Keep on Humming

Emerging equity and bond markets swooned in the immediate aftermath of Donald Trump's election victory last November. The administration's aggressive trade stance has since included picking a fight with Mexico over the North American Free Trade Agreement (NAFTA), formally disavowing the never-ratified Trans-Pacific Partnership agreement and appointing advisors well-known for their protectionist views. Congressional talk of a border-adjustment tax, which would levy a 20% tax on imported goods while exempting exports, certainly did not help matters. Emerging markets have nonetheless managed to climb this big, beautiful wall of worry. As Exhibit 13 shows, the MSCI Emerging Markets Index (Total Return) is in new cycle-high territory in both local-currency and U.S. dollar terms. In similar fashion, emerging-market bond yields have declined, with option-adjusted spreads reaching multi-year lows versus U.S. Treasurys.

Exhibit 13: Emerging, No Longer Submerging



Source: MSCI, SEI

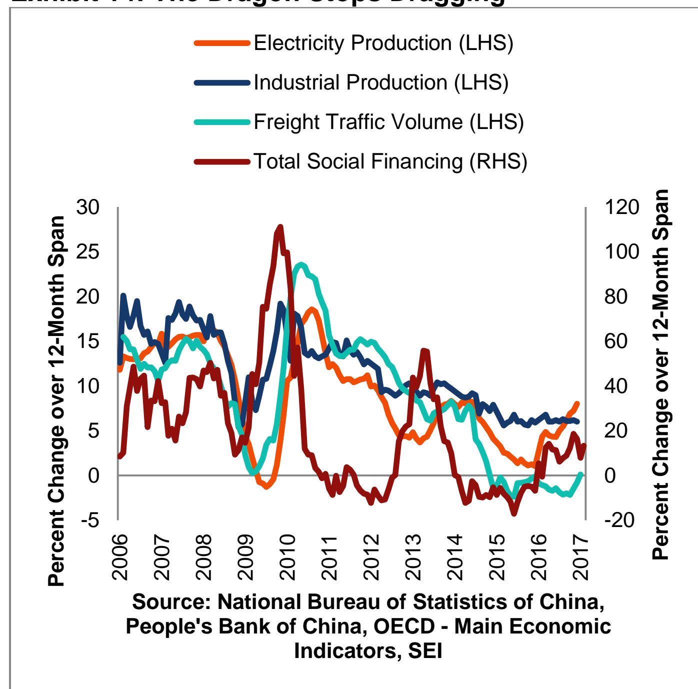
Investors seem to be taking a more relaxed view of the future, assuming that the Trump administration's bark is much worse than its bite. The president recently (at least as of this writing) has refrained from bashing Mexico and NAFTA in his tweets, for example. Nor has he turned his attention toward China as vociferously as we had feared. In addition, the border-adjustment tax may never see the light of day as it is being attacked from all sides; although the House Congressional leadership still hopes to have the controversial measure in their version of the tax bill. We would note that, since Inauguration Day on January 20, the Mexican peso has climbed against the dollar by more than 10% and is at a stronger level than had prevailed immediately prior to the U.S. presidential election.

That said, we think it's too early in the game to assume that President Trump's protectionist leanings will be subdued completely by the reality of governance. The president has truly surrounded himself with a team of rivals when it comes to Cabinet members and advisors who will be involved in trade issues. Indeed, more than two months after Inauguration Day, there are trade-related appointees still going through the senatorial vetting process. We doubt the administration will ever be able to speak with a unified voice when it comes to trade and other international matters. Of course, investors should keep in mind that the president has the final say, and seems focused on delivering on his promise to reduce import competition and bring manufacturing capacity back to the U.S. The president's most controversial senior advisor, Stephen Bannon, calls the administration's approach "economic nationalism." How that concept — which the president appears to have fully embraced — is implemented will set the tone of trade relations for years to come. At this point, we cannot rule out more trade-war scares in the months ahead.

We previously noted that a synchronized global expansion appears to be under way for the first time since the initial recovery from of the depths of the 2007-to-2009 recession. In that earlier period, China led the way to higher economic ground with a debt-infused boom, while the U.S. played an important secondary role. This time around, the focus has been on an upsurge in enthusiasm for the Trump administration's tax and regulatory reform efforts. Now China has the role of best-supporting actor on the world stage.

Exhibit 14 highlights that the Chinese economy is responding to the fiscal and monetary stimulus its government set in motion in 2015, when the country's financial markets were going through a period of intense stress. On a year-over-year basis, total social financing (a broad measure of credit and liquidity) is running at a nominal rate of 15% to 20%. This latest expansion is much lower than the peak rates reached in 2009 and 2013, but strong enough to spark a growth rebound in some of the more reliable measures of economic activity (such as freight traffic and electricity production). We note that industrial production in China has not yet begun to accelerate, remaining near a 6% annual rate. We think this lagging performance reflects the government's efforts to shut down some of the less economically profitable mining and manufacturing operations that have been the source of excess global supply. World commodity prices have strengthened as a result.

Exhibit 14: The Dragon Stops Dragging

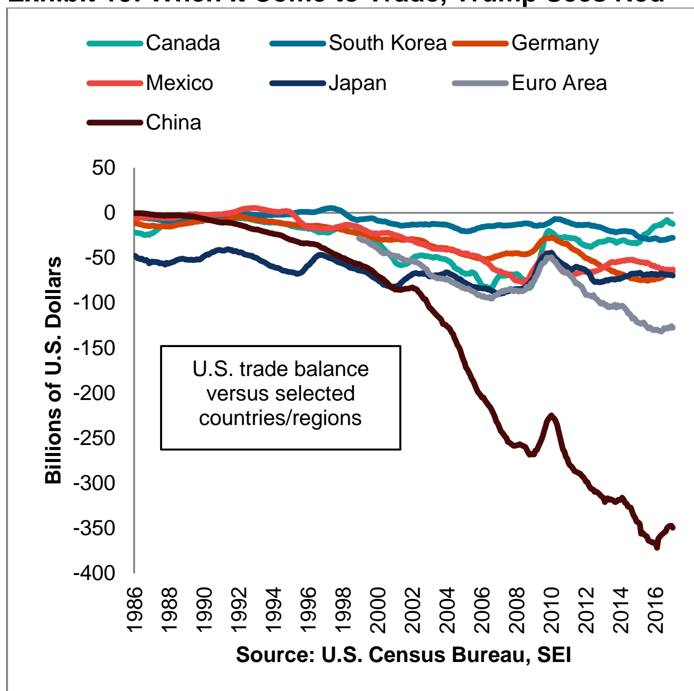


Source: National Bureau of Statistics of China, People's Bank of China, OECD - Main Economic Indicators, SEI

China's merchandise trade surplus, meanwhile, has eased significantly. Measured on a 12-month rolling basis, the trade surplus peaked in 2015 at $600 billion. As of February, the rolling surplus was down to about $450 billion. Imports have risen in the past year as China continues the process of shifting its economic model from an export/industrial focus to a consumer/services one. Exports to the U.S. have risen, however, even as they decline modestly to other regions of the world. China still runs a trade balance with the U.S. that is twice the magnitude of its surplus with the EU. Against the rest of the world, China's surplus over the past year has been cut in half to $100 billion, mostly reflecting the impact of rising oil and metals prices.

This reduction in the China surplus probably will not impress the Trump administration. Exhibit 15 compares the U.S. trade deficit to those of several different countries. This is viewed from the perspective of the U.S., which includes Chinese re-exports through Hong Kong as well as the cost of insurance and freight of imports coming into the U.S. Rather than concentrate on absolute U.S. dollar values, we believe it's better to focus on trends and relative magnitudes. On this basis, China remains by far the single biggest contributor to the U.S. merchandise trade deficit. The U.S. deficit against the EU is less than two-fifths the magnitude. It's also worth noting that Mexico's surplus with the U.S. is about the same size as those of Germany and Japan.

Exhibit 15: When It Come to Trade, Trump Sees Red



Source: U.S. Census Bureau, SEI

In view of the huge trade imbalance versus China, we remain concerned that the Trump administration will still name China a currency manipulator and/or levy punitive tariffs on industries and goods. A tit-for-tat trade war, combined with geopolitical tensions over China's island-building, could derail an otherwise promising global macroeconomic environment.

We anticipate that the Chinese government will not make too many waves economically or politically into the run-up to the 19th National Congress of the Communist Party of China in October, when the country's leadership will be reshuffled and Chairman Xi Jinping will presumably consolidate his hold on power. And so, we expect to see a continuation of the country's steady-to-better growth. At the same time, however, we note that property markets have gotten somewhat frothy again, and producer prices have shifted from deflation to a high inflation of 15%-plus in a year's time. The prospect of another tightening cycle, however, has not yet fazed investors in Chinese equities — or in other major emerging markets. The MSCI China Index (Total Return) has climbed 14% year to date.

The Indian stock market has enjoyed a similar gain, with somewhat surprising performance of Indian equities. The country's economy was badly disrupted by Prime Minister Narendra Modi's demonetization efforts, whereby high-denomination rupee notes were taken out of circulation in order to force economic activity out of the black market and into the recorded economy. However, investors' faith in the prime minister's agenda was unshaken. On the contrary, they have responded positively to Mr. Modi's continued popularity — most recently demonstrated by the resounding victory of his Bharatiya Janata Party in Uttar Pradesh, the country's most populous state. The electoral result raises hopes that his hand will be strengthened enough to push through more economic reforms more quickly. Yet there are signs that the Prime Minister is encouraging a rise in Hindu nationalism in his efforts to achieve a dominant Upper House majority over the next couple of years; resultant religious sectarianism between Hindus and Muslims has the potential of spooking investors somewhere along the line.

Elsewhere, Brazil has logged decent year-to-date performance of 10%, total-return in U.S. dollar terms, according to the MSCI Brazil Index. The economy remains in recession; although the year-over-year declines in real GDP have been decelerating (Exhibit 16). Investors are optimistic that the country's deep recession is drawing to a close. The Brazilian trade surplus has reached record levels in recent years, running at a sustained pace that is roughly twice the previous high-water mark seen during the 2004-to-2006 period. However, this has occurred via a sharp decline in imports owing to the deep recession. The Brazilian real's sharp recovery against the U.S. dollar over the past year also has helped to push the rate of inflation down to almost 5% on year-over-year basis. Just a year ago, the inflation rate was close to 11%. As a result of this improvement, interest rates have begun to slide across the yield curve. The country's central bank has cut policy rates by two percentage points; however, at 12%, they remain well above the inflation rate.

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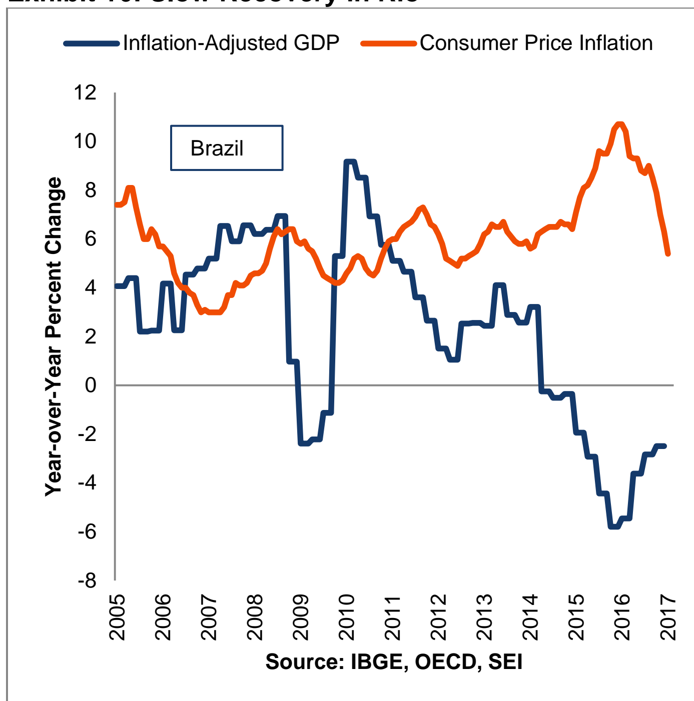
Exhibit 16: Slow Recovery in Rio



Source: IBGE, OECD, SEI

Although the political environment remains volatile, President Michel Temer is making progress turning Brazil into a more business-friendly country. The government also appears to be bringing discipline to the country's finances, recently passing a landmark law that limits future increases in government spending to the inflation rate. Pension reform, aimed at lifting the retirement age to 65 from the current average of age 54 could be passed as early as the second quarter of this year. Labor, education and tax reforms also are planned to take place before the next elections in 2018.

Our emerging-market equity portfolios remain overweight Brazil and Argentina, which is also undergoing economic reforms. More generally, our portfolios continue to be positioned for further expansion of the middle classes in emerging economies, with an overweight to the consumer staples sector (although valuations appear stretched on a near-term basis). There is also a growing emphasis on financials, as the banking system heals in places like India. India remains an attractive secular story. Our portfolios are underweight the larger Asian countries (China, Korea and Taiwan) in favor of smaller countries like Thailand and Indonesia. Our portfolios are increasing the weight of so-called frontier markets; this naturally leads to a structural underweight to the technology sector. We remain bearish on South Africa, Turkey and the Philippines, countries with problematic politics and economic policies.

With regard to emerging-market debt, Brexit's impact on eastern European countries is an important concern; as a result, Poland and Hungary are underweights. The political and economic changes in Latin America, by contrast, have led to overweights to Mexico, Brazil and Argentina. From a currency perspective, our portfolios are overweight local versus U.S.-dollar sovereign debt. We favor higher-yielding currencies, with overweight exposure to the Mexican peso and underweight exposures to the Japanese yen, Korean won and Singapore dollar.

The Bottom Line: Stay the Course

There's no denying that the "Trump reflation" trade began to fade toward the end of the first quarter as efforts to repeal and replace the U.S. Affordable Care Act ran up against internal Republican Party divisions within Congress. The inability to push through healthcare legislation is a defeat for the administration and complicates the coming debate over tax reform. But we firmly believe it is a mistake to think that political gridlock is an unchanging reality in Washington.

Our bedrock assumptions remain intact: The U.S. economy will continue to expand; although a step-up in that growth rate will hinge on how successfully the Trump administration pushes through legislation and rule changes that reduce the cost of doing business, improve incentives to invest and enhance the quality and productivity of the labor force. This takes time, but markets will likely be quick to anticipate secular improvement if legislative activity points in the right direction.

In our opinion, the valuation of U.S. equities is a moderate concern at this point. Granted, economic, earnings, and political disappointments are not as easily ignored now as they might be at lower valuation levels. Nonetheless, until interest rates start to rise at a faster-than-anticipated pace, or the economy shows early signs of entering a recession, we will continue to view price corrections as buying opportunities. In the meantime, the world economy appears to be on the mend. Geographically diversified equity portfolios that have had a tough time keeping up with the S&P 500 Index may begin to outperform.

In fixed-income markets, we expect the normalization of interest rates reaching higher levels to proceed at a rather sedate pace. For the most part, inflation is not the global economy's biggest problem. It is the lack of growth. That seems to be changing, but we do not foresee aggressive tightening by central banks. The Fed may be leading the way, but even it is likely to tread carefully until inflation becomes a bigger problem. This should limit the danger of a debacle in the bond markets. It also provides a favorable backdrop for an equity market that continues to defy the naysayers.

Definitions

Basis point: 100 basis points equals one percent.

Bloomberg Barclays EM USD Sovereigns Index: The Bloomberg Barclays Emerging Markets USD Sovereign Index tracks fixed and floating-rate US dollar-denominated debt issued by sovereign EM issuers. Corporate issues are not eligible.

Bloomberg Barclays U.S. Aggregate Bond Index: The Barclays U.S. Aggregate Bond Index is an unmanaged benchmark index composed of U.S. securities in Treasury, Government-Related, Corporate, and Securitized sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $250 million.

Bloomberg Barclays U.S. Corporate High Yield Bond Index: The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the U.S. dollar-denominated high-yield fixed-rate corporate-bond market.

Broad Trade-Weight Dollar Index: The trade-weighted U.S. dollar index, also known as the broad index, is a measure of the value of the U.S. dollar relative to other world currencies.

CRB Spot Index: The CRB BLS Spot Index tracks 22 commodities presumed to be among the first influenced by changes in economic conditions.

JP Morgan Nominal Broad Effective Exchange Rate Index: The JP Morgan Nominal Broad Effective Exchange Rate Index tracks a currency's performance in the Forex (fx) market to determine how exchange-rate changes impact the host country's inflation outlook.

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

MSCI Brazil Index: The MSCI Brazil Index is designed to measure the performance of the large- and mid-cap segments of the Brazilian market. With 60 constituents, the index covers about 85% of the Brazilian equity universe.

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

MSCI Emerging Markets Index: The MSCI Emerging Markets Index is a free float-adjusted market capitalization weighted index designed to measure the performance of global emerging market equities.

MSCI Europe Growth Index: The MSCI Europe Growth Index captures large- and mid-cap securities exhibiting overall growth style characteristics across 15 developed-market countries in Europe.

MSCI Europe Value Index: The MSCI Europe Value Index captures large- and mid-cap securities exhibiting overall value style characteristics across 15 developed-market countries in Europe.

MSCI UK Total Return Index: The MSCI UK Total Return Index is designed to measure the performance of the large- and mid-cap segments of the U.K. market. The MSCI Total Return Indices measure the price performance of markets with the income from constituent dividend payments.

MSCI US Total Return Index: The MSCI US Total Return Index is designed to measure the performance of the large- and mid-cap segments of the U.S. market. The MSCI Total Return Indices measure the price performance of markets with the income from constituent dividend payments.

MSCI World ex-US Index: The MSCI World ex-U.S. 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 ex-US Index consists of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom.

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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 indices.

Option-adjusted spreads: A calculation used to help determine price differences between similar products that allow different embedded options.

Personal Consumption Expenditures Price Index: The Personal Consumption Expenditures Price Index measures price changes in consumer goods and services

Russell 1000 Index: The Russell 1000 Index includes 1000 of the largest U.S. equity securities based on market cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.

Russell 2000 Index: The Russell 2000 Index includes 2000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.

S&P 500 Index: The S&P 500 Index is a market-capitalization weighted index that consists of 500 publicly traded large U.S. companies that are considered representative of the broad U.S. stock market.

S&P 600 Index: The S&P 600 Index is a market-capitalization-weighted index that measures the small-cap segment of the U.S. equity market.

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