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QUARTERLY MARKET COMMENTARY | Q1 2017

Presidential Torch-Passing and a Brexit Bookend

Quarterly Snapshot

- The quarter began with global anticipation of a Donald Trump U.S. presidency giving way to his inauguration, followed by a turbulent acclimation period; and it ended with formal notice of Great Britain's intent to leave the European Union.
- Fixed-income markets were unanimously positive, propelled by higher-risk market segments. Equity markets advanced for much of the quarter, posting strong performance.
- 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 equity-market price corrections as buying opportunities.

Economic Backdrop

Anticipation of a Donald Trump U.S. presidency gave way early in the first quarter to his January inauguration, followed by a turbulent acclimation period as the new administration wrestled with the constraints of governing in the face of heavy opposition (from both outside and within President Trump's party), in addition to critical media and unrelenting controversy. The quarter ended with what will likely be the start of a more enduring shift: U.K. Prime Minister Theresa May's formal commencement of Great Britain's withdrawal from the European Union (EU), setting the stage for several years of negotiations centered on the divorce and future relationship of the two areas.

Equity markets advanced globally for much of the quarter, yet encountered some resistance in March as Trump's agenda was set back by a scuttled attempt at healthcare reform that left investors wondering whether his business-friendly tax and regulatory reforms would be delayed or similarly stymied. Bond yields generally finished the quarter a bit lower (yields and prices have an inverse relationship), hitting a period high in mid-March before staging a steep retreat; emerging-market yields notably declined.

The U.S. Federal Reserve (Fed) delivered a widely expected quarter-point interest-rate increase following its mid-March meeting, and maintained its target projection of two additional rate hikes for the remainder of 2017. The turnaround in bond-market yields following the announcement was likely attributable to expectations for a revised Fed projection showing more increases, which did not materialize. The central banks of England and Japan held their respective accommodative monetary-policy stances firm during the quarter. The European Central Bank (ECB) also declined to make changes, but confirmed that monthly bond purchases would begin to taper from €80 to €60 billion starting early in the second quarter.

U.S. retail sales growth declined during the first quarter but was strong on a seasonal basis (given that sales tend to significantly contract following the holidays), which is consistent with the historically high consumer sentiment reflected in first-quarter surveys. Consumer prices continued a slow upward trend, with a 1.8% year-over-year increase in February for core

Key Measures: Q1 2017

EQUITY	
Dow Jones Industrial Average	5.19% ↑
S&P 500 Index	6.07% ↑
NASDAQ Composite Index	10.13% ↑
MSCI AC World Index (Net)	6.91% ↑
BOND	
Bloomberg Barclays Global Aggregate Index	1.76% ↑
VOLATILITY	
Chicago Board Options Exchange Volatility Index PRIOR: **14.04**	12.37 ↓
OIL	
WTI Cushing crude oil prices PRIOR: **$53.72**	$50.60 ↓
CURRENCIES	
Sterling vs. U.S. dollar	$1.25 ↑
Euro vs. U.S. dollar	$1.07 ↑
U.S. dollar vs. yen	¥111.43 ↓

Sources: Bloomberg, FactSet, Lipper

personal consumption expenditures (the Fed's preferred inflation gauge, which excludes food and energy given their volatility). Average-earnings growth continued apace, but real-income growth showed modest signs of inflationary erosion. The unemployment rate fell to 4.7% in February from 4.8% in January, in concert with a rising labor-force participation rate. Fourth-quarter economic growth slowed to an annualized 2.1% from 3.5% in the third quarter.

U.K. industrial trends were mixed, with orders for manufactured goods holding through March at recent highs — suggesting that gains have levelled off. Construction activity also steadily expanded, albeit quite slowly throughout the quarter. Retail activity started the three-month period on a soft note, but partially rebounded in February and appeared to have maintained progress in March. Employment trends continued to brighten (although the most inclusive data is on a significant lag), while average year-over-year earnings slid for the third consecutive report. Economic growth expanded by 0.7% in the fourth quarter and 1.9% year over year.

Eurozone manufacturing activity expanded at an accelerating pace for the seventh straight month, hitting a six-year peak, while the services sector told a similar story. The jobless rate fell throughout the first two months of the quarter, reaching 9.5% in February, with elevated youth unemployment shrinking two times faster than the broad labor market. Economic sentiment began the first quarter with continued gradual improvement, peaking in January, but maintaining the highest readings in almost six years through February and March. Consumer prices capped a five-month climb at 2.0% year over year in February and retreated in March (according to early data). The eurozone economy expanded by 0.4% during the fourth quarter — a pickup from the previous quarter.

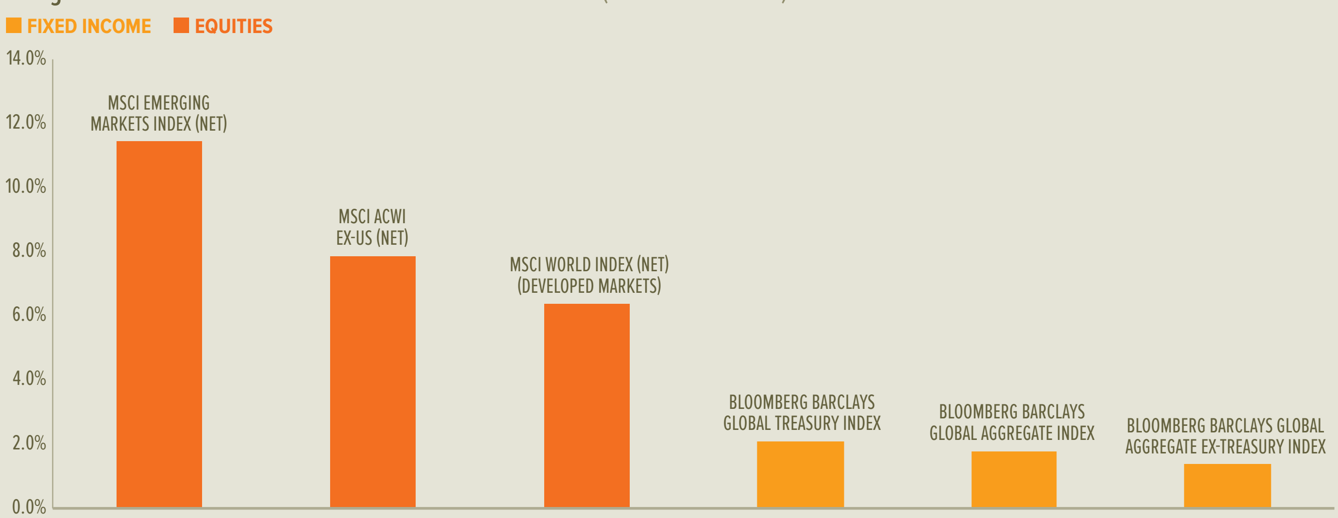
Portfolio Review

U.S. large-cap stocks put in another strong quarter, while small caps advanced by considerably less. Growth strategies rebounded across the capitalization spectrum and value lagged as energy prices slid. Large-cap strategies benefitted from a significant underweight to the energy sector, yet a slight overweight to other value segments detracted; stock selection in consumer discretionary, consumer staples and technology detracted most. Small-cap strategies gained on a large overweight to technology, but were held back by positioning in healthcare (via an underweight to the volatile biotechnology segment), energy and industrials. Overseas, developed-market performance was bolstered by selection in Europe and exposure to growing Asian markets. Value-oriented companies presented select opportunities despite an overall style headwind; the international strategy received a boost from an overweight to technology, as well as selection in consumer discretionary and healthcare. Emerging-market equity strategies had an especially strong quarter, due in part to underweight positioning and selection in Asia. Latin American positioning slightly detracted from relative performance, but benefited from an off-benchmark allocation to Argentina.

Core fixed-income strategies performed well during the first quarter on the strength of non-government sector exposures. A modest long-duration posture and yield-curve-flattening bias were additive, as short-term rates increased and long-term rates fell. Financial- and industrial-sector bonds led the corporate segment, benefitting from an overweight to financials. Non-agency mortgage-backed securities (MBS) exposure continued to benefit from a strong housing market and limited issuance, while an underweight to sub-prime auto securitizations supported overall performance from asset-backed securities (ABS). Commercial mortgage-backed securities (CMBS) delivered modest excess returns despite scrutiny of retail properties with big-box store closure headlines; selection was especially beneficial given our higher-quality holdings. An underweight to agency MBS supported relative performance amid relatively minor interest-rate changes during the quarter. Within high yield, an overweight to and security selection within healthcare was the top contributor, followed by selection within media and leisure. Selection in energy was the most significant detractor, followed by positioning in retail and transportation. A strong quarter for high-yield bonds meant that defensive holdings in bank loans and cash tempered strategy performance. In emerging markets, our overweight to local-currency bonds (which were the top-performing fixed-income segment) and underweight to foreign-currency bonds were both key contributors. A significant overweight to Mexico delivered the greatest country-level benefit (as the peso recovered from an all-time low), followed by an overweight to Argentina (which gained on earnest reforms). An underweight to South Korea detracted most, followed by an underweight to Singapore and an overweight to Ukraine.

Non-agency mortgage-backed securities exposure continued to benefit from a strong housing market and limited issuance, while an underweight to sub-prime auto securitizations supported overall performance from asset-backed securities.

Major Index Performance in Q1 2017 (Percent Return)



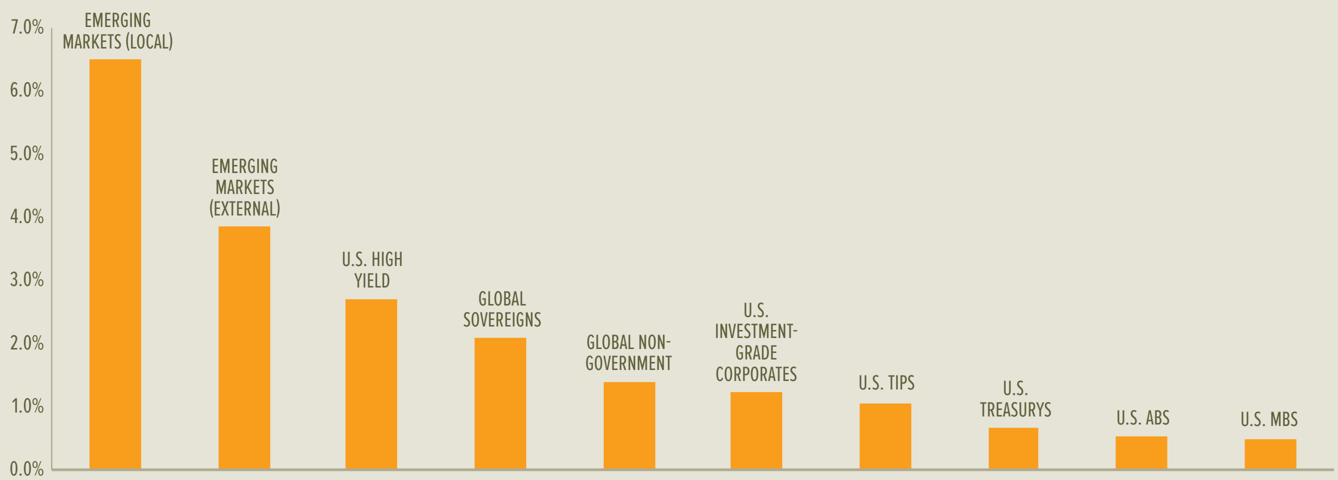
Sources: FactSet, Lipper

Manager Positioning and Opportunities

U.S. stock valuations are becoming stretched by optimism for the Trump administration's pro-growth policies; we are therefore mindful of the possibility that double-digit earnings growth may not come through as anticipated. Large- and small-cap positioning was defensive, with an emphasis on stability and sustainable-growth strategies at the expense of value and momentum. In developed international markets, we retained an overweight to technology given the sector's growth prospects irrespective of global macro conditions. The strategy was underweight financials, consumer staples and telecommunications, and increased its weight to industrials. Regionally, the strategy was underweight Japan and Australia. Within emerging markets, while Asia is our strategy's largest absolute regional exposure, it remained underweight compared to the benchmark — primarily via reduced weights to more-developed countries like Korea and Taiwan, where valuations tend to be higher and growth rates are lower. We retained a positive long-term view on China, which was slightly underweight (yet our largest absolute country weight). India remained overweight on the premise of accelerating economic growth and a reform-minded government. Our emphasis in Latin America centered on Brazil, as it emerges from a difficult period and oil prices mount an uneven recovery.

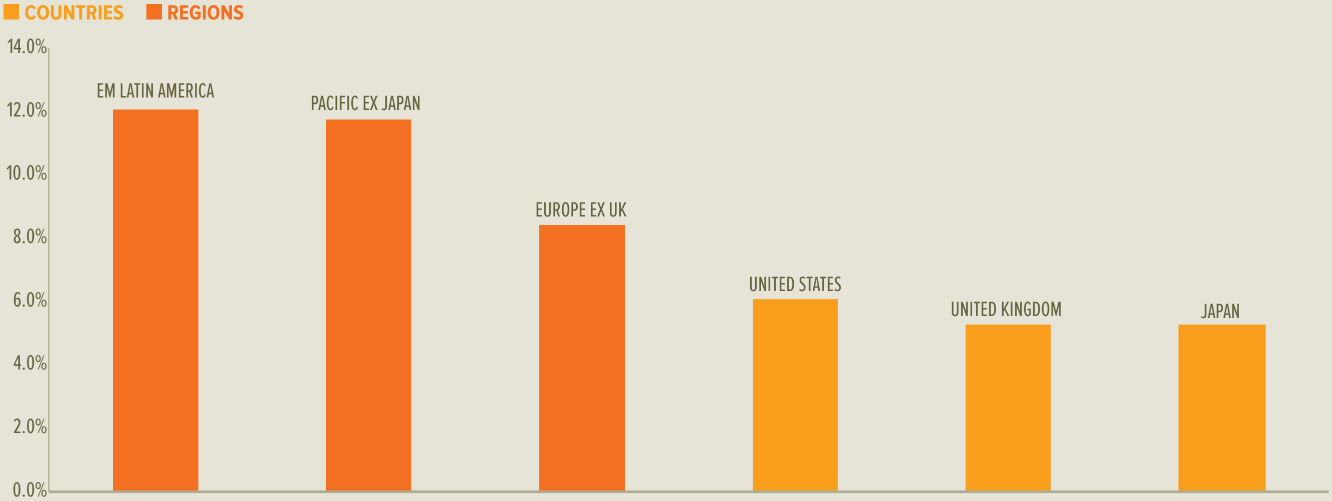
Core fixed income reduced exposure to bonds that exceeded valuation targets, as we believe a heavy new-issuance calendar could provide opportunities to add risk at more favorable levels. Duration positioning remained roughly neutral, but responsive to interest-rate changes. The strategy's curve-flattening bias was adjusted by increased exposure to long-term rates as the curve continued to steepen in early 2017. An overweight to financials within the corporate space was maintained, and remains attractive given strong bank capital positions and the potential for U.S. regulatory easing. We continued to overweight ABS and CMBS

Fixed-Income Performance in Q1 2017 (Percent Return)



Sources: FactSet, Lipper. See "Corresponding Indexes for Fixed-Income Performance Exhibit" in the Index Descriptions section for more information.

Regional Equity Performance in Q1 2017 (Percent Return)



Sources: FactSet, Lipper. See “Corresponding Indexes for Regional Equity Performance Exhibit” in the Index Descriptions section for more information.

given their competitive risk-adjusted yields, as well as non-agency MBS, while remaining vigilant about the potential for rising rates to weigh on the housing market. Positioning within high-yield debt continued to emphasize exposure to collateralized-loan obligations given their compelling values; this was offset by underweights to basic industry, capital goods, energy, telecommunications and banking. Emerging-market debt positioning remained substantially underweight to foreign-currency bonds, significantly overweight to local-currency debt and moderately overweight to corporates. At the country level, Argentina remained the largest overweight, followed closely by Mexico, while China remained underweight. The largest currency overweight exposure was to the Mexican peso, followed by the Colombian peso, while the most significant underweight exposure was to China’s renminbi.

Our View

In the U.S., there’s no denying that the “Trump reflation” trade began to fade toward the end of the first quarter as healthcare-reform efforts ran up against internal divisions between Congressional Republicans, complicating the coming debate over tax reform. We expect the U.S. economy will continue to expand, although a step-up in growth will likely hinge on how successfully the Trump administration pushes through pro-cyclical legislation and rule changes.

We are witnessing the strongest synchronized advance in European economic data across developed and emerging economies since the 2009-to-2010 period. As a major exporting region, broad improvement in global activity is good news. The ECB will likely be slow to ease off the gas pedal, despite all the talk of tapering its bond-buying program, as it does not want to repeat the mistake it made in 2011 of prematurely hiking interest rates.

In France, a path to electoral victory has opened for independent candidate Emmanuel Macron. His economic reform proposals seem less extreme and more in keeping with the sensibilities of the average French voter; 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 populist National Front now appears much reduced.

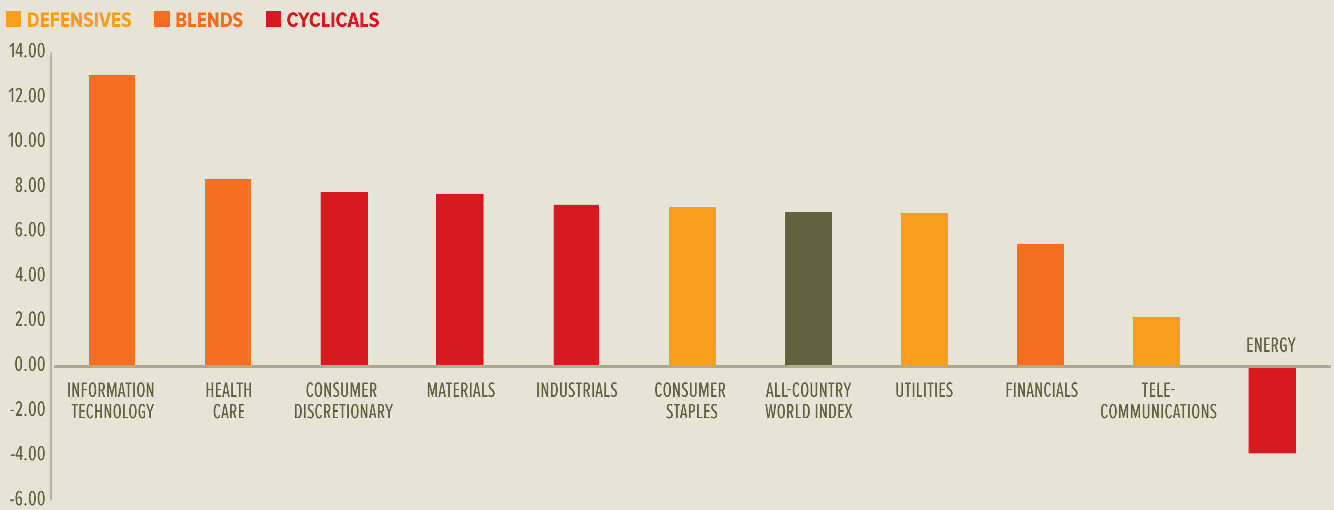
Investors remain nervous about Europe's periphery; Italian bond yields, for example, remain close to a two-year high in absolute terms and at a three-year high relative to German bunds. Although progress is being made in recapitalizing Italy's banking system and writing off bad debt, it will be a multi-year process before it is on sounder footing.

U.K. Prime Minister Teresa May has started the clock on Great Britain's exit from the EU. Like many other observers, we have been surprised at how well the economy has performed since the referendum. Although inflation pressures seem to building, it doesn't look as if the Bank of England is in a rush to tighten policy. The uncertainties surrounding Brexit are too great.

Hopes for a soft Brexit have faded in recent months, as May's government 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 — based on an estimate of net liabilities owed by the U.K. — before substantive discussions have even begun. It is a bad start to a challenging process.

Emerging equity and bond markets swooned in the immediate aftermath of Trump's November victory in response to the incoming administration's aggressive trade stance, but have since begun to climb a big, beautiful wall of worry. 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.

Global Equity Sector Performance in Q1 2017 (Percent Return)



Sources: FactSet, Lipper. MSCI All-Country Sector Components (as defined by 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. That being said, it's important to keep in mind that President Trump has the final say — and he seems intent to deliver on his promise to reduce import competition and bring manufacturing capacity back to the U.S.

During the last synchronized global expansion following the 2007-to-2009 recession, China led the way to higher economic ground with a debt-infused boom, while the U.S. played an important secondary role. This time the focus has been on enthusiasm for the Trump administration's tax and regulatory reform efforts. Now China has the role of best-supporting actor on the world stage.

The Chinese economy is responding to the fiscal and monetary stimulus set in motion by the government in 2015, when the country's financial markets were going through a period of intense stress. This latest expansion is much lower than the peak rates reached in 2009 and 2013, but strong enough to spark a growth rebound within more-reliable measures of economic activity.

Imports have risen in the past year, as China continues the process of shifting its economic model from focusing on export/industrial to focusing on consumer/services. Exports to the U.S. have risen, however, even as they decline modestly to other regions of the world. China remains, by far, the single-biggest contributor to the U.S. merchandise trade deficit. We are concerned that the Trump administration will still decide to name China a currency manipulator or levy punitive tariffs. A 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 economic or political waves into the run-up to the 19th Communist Party Congress in October, when the country's leadership will be reshuffled and Chairman Xi Jinping will presumably consolidate his hold on power. As such, we expect the country to continue its steady-to-better growth.

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 U.S. 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 anticipate the normalization of interest rates to higher levels to proceed at a sedate pace. We don't believe that inflation is the global economy's biggest problem. We believe it's a lack of growth. That seems to be changing, but we do not expect 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.

Hopes for a soft Brexit have faded in recent months, as May's government seeks severe limits on the free movement of people from the EU and takes back sovereignty from the European Court of Justice.

Index Descriptions

All indexes are quoted in gross performance unless otherwise indicated.

The Bloomberg Barclays 1-10 Year U.S. TIPS Index measures the performance of inflation-protected public obligations of the U.S. Treasury that have a remaining maturity of one to ten years.

The Bloomberg Barclays U.S. Asset Backed Securities (ABS) Index measures the performance of ABS with the following collateral types: credit and charge card, auto and utility loans. All securities have an average life of at least one year.

The Bloomberg Barclays Global Aggregate Bond Index is an unmanaged market-capitalization-weighted benchmark that tracks the performance of investment-grade fixed-income securities denominated in 13 currencies. The Index reflects reinvestment of all distributions and changes in market prices.

The Bloomberg Barclays Global Aggregate ex-Treasury Index is an unmanaged market index representative of the total return performance of ex-Treasury major world bond markets.

The Bloomberg Barclays Global Treasury Bond Index is composed of those securities included in the Bloomberg Barclays Global Aggregate Bond Index that are Treasury securities.

The Bloomberg Barclays U.S. Corporate Investment Grade Index is a broad-based benchmark that measures the investment-grade, fixed-rate, taxable corporate bond market.

The Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index measures the performance of investment-grade, fixed-rate, mortgage-backed, pass-through securities of Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) and Freddie Mac (FHLMC).

The Bloomberg Barclays U.S. Treasury Index is an unmanaged index composed of U.S. Treasurys.

The BofA Merrill Lynch U.S. High Yield Constrained Index contains all securities in The BofA Merrill Lynch US High Yield Index but caps exposure to individual issuers at 2%. The BofA Merrill Lynch US High Yield Index tracks the performance of below-investment-grade, U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Chicago Board Options Exchange Volatility Index (VIX) tracks the expected volatility in the S&P 500 Index over the next 30 days. A higher number indicates greater volatility.

The Dow Jones Industrial Average is a widely followed market indicator based on a price-weighted average of 30 blue-chip New York Stock Exchange stocks that are selected by editors of The Wall Street Journal.

The FTSE All-Share Index represents 98-99% of U.K. equity market capitalization. The Index aggregates the FTSE 100, FTSE 250 and FTSE Small Cap Indexes.

The JPMorgan EMBI Global Diversified Index tracks the performance of external debt instruments (including U.S. dollar-denominated and other external-currency-denominated Brady bonds, loans, Eurobonds and local market instruments) in the emerging markets.

JPMorgan GBI-EM Global Diversified Index tracks the performance of debt instruments issued in domestic currencies by emerging-market governments.

The MSCI All Country World Index is a market-capitalization-weighted index composed of over 2,000 companies, and is representative of the market structure of 46 developed and emerging-market countries in North and South America, Europe, Africa, and the Pacific Rim. The Index is calculated with net dividends reinvested in U.S. dollars.

The MSCI All Country World ex-US Index includes both developed and emerging-market countries, excluding the U.S.

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

The MSCI Emerging Markets Latin America Index captures large- and mid-cap representation across five emerging-market countries in Latin America.

The MSCI EMU Index (European Economic and Monetary Union) Index is a free float-adjusted market-capitalization-weighted index designed to measure the equity market performance of countries within EMU. The MSCI EMU Index consists of the following 10 developed-market country indexes: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal and Spain.

The MSCI Europe ex-UK Index is a free float-adjusted market-capitalization-weighted index that captures large- and mid-cap representation across 14 developed markets countries in Europe (Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden and Switzerland). The Index covers approximately 85% of the free float-adjusted market capitalization across European developed markets, excluding the U.K.

The MSCI Pacific ex Japan Index captures large- and mid-cap representation across four of five developed-market countries in the Pacific region (excluding Japan).

The MSCI World Index is a free float-adjusted market-capitalization weighted index designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 23 developed market country indexes: 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, and the United States.

The NASDAQ Composite Index is a market value-weighted index of all common stocks listed on the National Association of Securities Dealers Automated Quotations (NASDAQ) system.

The S&P 500 Index is a capitalization-weighted index made up of 500 widely held U.S. large-cap companies.

The TOPIX, also known as the Tokyo Stock Price Index, is a capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The Index is supplemented by the subindexes of the 33 industry sectors. The index calculation excludes temporary issues and preferred stocks, and has a base value of 100 as of January 4, 1968.

Corresponding Indexes for Fixed-Income Performance Exhibit

U.S. High Yield	BofA Merrill Lynch U.S. High Yield Master II Constrained Index
Global Sovereigns	Bloomberg Barclays Global Treasury Bond Index
Global Non-Government	Bloomberg Barclays Global Aggregate ex-Treasury Index
Emerging Markets (Local)	JPMorgan GBI-EM Global Diversified Index
Emerging Markets (External)	JPMorgan EMBI Global Diversified Index
U.S. Mortgage-Backed Securities (MBS)	Bloomberg Barclays U.S. Mortgage Backed Securities Index
U.S. Asset-Backed Securities (ABS)	Bloomberg Barclays U.S. Asset-Backed Securities Index
U.S. Treasurys	Bloomberg Barclays U.S. Treasury Index
U..S. Treasury Inflation-Protected Securities (TIPS)	Bloomberg Barclays 1-10 Year U.S. TIPS Index
U.S. Investment-Grade Corporates	Bloomberg Barclays U.S. Corporate Investment Grade Index

Corresponding Indexes for Regional Equity Performance Exhibit

United States	S&P 500 Index
United Kingdom	FTSE All-Share Index
Pacific ex Japan	MSCI Pacific ex Japan Index (Net)
Japan	TOPIX, also known as the Tokyo Stock Price Index
Europe ex UK	MSCI Europe ex UK Index (Net)
EM Latin America	MSCI Emerging Markets Latin America Index (Net)

Disclosures

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