Economic Outlook

Second Quarter 2019

Still Climbing that Big, Beautiful Wall of Worry

By: James R. Solloway, CFA, Chief Market Strategist and Senior Portfolio Manager

- There is deep-seated anxiety that the bull market in global equities will soon come to an end.
- We believe there is still life in the economic expansion, both in the U.S. and globally.
- For our view to change, financial and leading economic indicators would need to severely deteriorate.

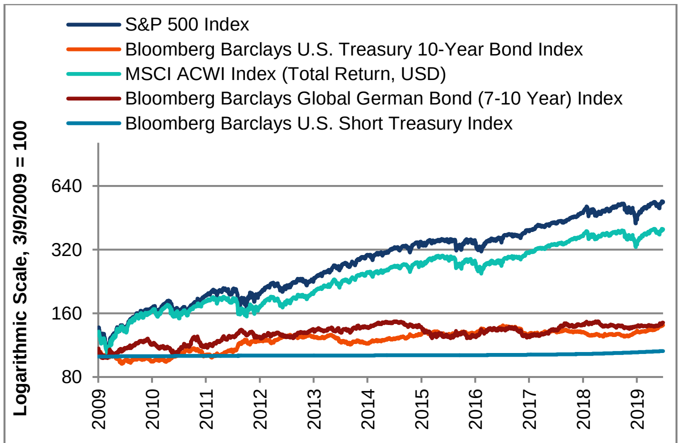
July marks the tenth anniversary of the U.S. economic expansion. The bull market in U.S. equities (as measured by the S&P 500 Index) reached its tenth birthday in March. The S&P 500 Index seemed to celebrate these achievements just a few weeks ago by moving into new-high territory—but there now seems to be more fear than cheer on Wall Street. There is deep-seated anxiety that the bull market in equities is on its last legs, the victim of a slowing global economy, the lagged impact of last year's interest-rate increases and, perhaps most importantly, a worsening trade war between the U.S. and China. The last concern threatens to substantially upend the key economic relationship of the past two decades.

Some observers believe the economic and political headwinds are now blowing strong enough to push the U.S. and global economy into recession. If they are right, this would a bear market in equities and other risk-oriented assets like emerging-market and high-yield debt. SEI strongly disagrees with this pessimistic assessment. We believe there is still life in the economic expansion, both in the U.S. and globally. That means corporate profits should continue to expand and push global stock markets to higher levels in the months ahead. This may seem like a bold statement at a time when the world seems increasingly unpredictable and the economic data point to slowing growth. Yet we simply do not see the economic imbalances or nosebleed equity-market valuations that normally bring on recessions and an associated contraction in earnings and stock prices. Although one can point to the tariff war with China as a potentially costly policy development, we believe that view exaggerates the near-term impact. In the meantime, it is clear that central banks have investors' backs as monetary policymakers promise to cut interest rates (or already have) and provide additional liquidity to their banking systems in both developed and emerging countries.

Reviewing the Run

There is no denying that the bull market in U.S. equities has been one for the record books, both in terms of magnitude and duration. Other regions of the world have not enjoyed as consistent or strong a climb. Yet, even outside the U.S., stocks have outperformed bonds and cash over the past decade. Exhibit 1 shows the results.

Exhibit 1: Stocks and Bonds Set the Pace



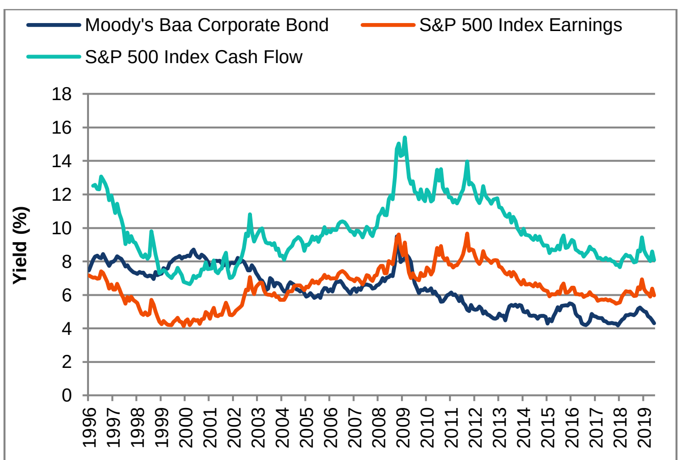
Source: Bloomberg Barclays, MSCI, S&P, SEI
Data as of 6/30/2019

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

Measuring from the bottom on March 9, 2009, the S&P 500 Index has climbed more than 440% in total-return terms through the end of June 2019. This benchmark of the U.S. equity market has defied the doom-and-gloom prognosticators time after time, most recently rebounding sharply from its late-December lows to reach new highs in late April and again in mid-June. A broader measure of equities, the MSCI ACWI Index (of which the U.S. is the largest component), has followed the same path as the S&P 500 Index—but has lagged a cumulative 140 percentage points, providing investors a total return of 300%. The MSCI Emerging Market Index achieved 178% in total returns from March 2009 through June 2019, while the MSCI World ex USA Index indicated that developed markets gained nearly 200% in the same period. U.S. and German 10-year bonds both posted cumulative total returns of just 41% and 45%, respectively, while cash (represented in Exhibit 1 by the Bloomberg Barclays U.S. Short Treasury Index) has returned a cumulative grand total of 6% since the March 2009 stock-market low. Investing in riskless assets has come at an exceedingly high price.

U.S. equities, in our opinion, still appear attractive, at least relative to bonds. Exhibit 2 compares Moody's Baa corporate bond yields to the earnings yield of the S&P 500 Index (which is earnings per share divided by its current price—that is, the reciprocal of its price-to-earnings ratio) and to the S&P 500 Index cash flow yield (which measures the cash flow per share—the funds that firms have available to spend after covering their operating costs, payments to debtholders, and taxes—of its constituent companies divided by the price of the stock index). This rough-and-ready relative-valuation measure shows that an unusually positive yield gap has opened up between equities and bonds (Baa corporates) since the financial crisis.

Exhibit 2: TINA (There Is No Alternative) Likes Stocks



S&P/Moody's bond ratings are measured on a scale that generally ranges from AAA/Aaa (highest) to D/C (lowest).

In May of this year, as stocks swooned and bond yields fell sharply, the yield gap widened dramatically in favor of equities. The earnings yield expanded to 188 basis points—even higher than the 180 basis points recorded at the end of 2018 at the stock market's lows. The S&P 500 Index's cash-flow yield spread over Moody's Baa corporate bonds increased to 410 basis points—not quite as steep a reading as the end of last year, but still the second highest since October 2016. In the absence of a recession or a complete meltdown of investor confidence, we believe that these yield spreads strongly support the case for maintaining exposure to equities versus bonds.

Of course, the valuation of equities relative to safer alternatives is not the primary consideration of stock investors. In the absence of growth, a cheap market can stay cheap—or get cheaper. Accordingly, the outlook for the economy and profits growth is critical. A static snapshot of the relationship between the asset classes makes equity yields look cheap relative to bonds, but if the economy were to fall into recession, earnings and the market's multiple on those stock-market earnings would likely contract sharply. It all comes down to one question: How likely is a recession in the next 6 to18 months?

Paul Samuelson, the Nobel Prize-winning economist (and author of a popular economics textbook that some of us may have read in college, *Economics: An Introductory Analysis*) made the humorous observation that economists have called nine of the last five recessions. That was back in 1966. Since then, economists probably have called at least 12 of the past seven recessions. Are the economists in danger of misreading the signs yet again? It seems so. At this point, most of them are only calling for a slowdown in gross domestic product (GDP) growth for 2019, not an outright recession. According to the June 2019 edition of the monthly "Economic Forecasting Survey[1]" of 60 economists conducted by the Wall Street Journal, only 4.9% of respondents expect a recession in 2019. However, a hefty 48.8% see a downturn developing sometime in 2020. An additional 36.6% of those surveyed are calling for a 2021 recession.

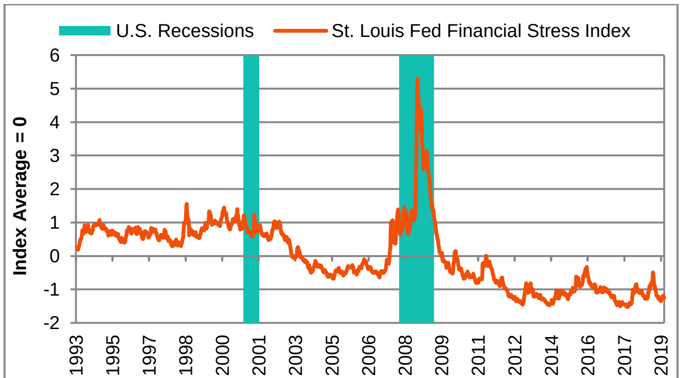
At SEI, we would need to see a severe deterioration in financial and leading economic indicators before climbing on the recession train. In our experience, the only time there is a decent chance of correctly calling a recession is six months ahead of the event. Accurately forecasting a recession one year in advance tends to be much more difficult, with perhaps a 50/50 chance of getting it right. Predicting a downturn 18 to 24 months out is almost impossible, in our opinion, since it requires making assumptions about monetary policy and financial conditions, which impact economic activity on a lag that is long and variable.

Even after the past two years of multiple Federal Reserve (Fed) rate increases, there are still few signs of a buildup in financial stress, according to the St. Louis Fed Financial Stress Index. Index components are designed to capture various aspects of financial stress, and include: a variety of interest-rate series (the federal-

[1] https://www.wsj.com/graphics/econsurvey/

funds rate, Treasury notes and bonds, investment-grade debt, and high-yield and emerging-market bonds); the Treasury yield curve; a variety of credit spreads; stock and bond volatility measures; the S&P 500 Financials Index; and a measure of breakeven inflation. Exhibit 3 shows that financial stress remains well below average, even though news headlines have become more foreboding on trade and global growth.

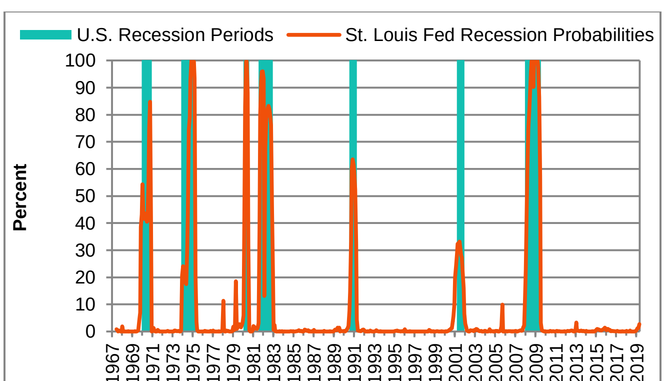
Exhibit 3: No Stress in the Stress Index



Source: Economic Cycle Research Institute, Federal Reserve Bank of St. Louis, SEI
Data as of 6/30/2019

Another handy statistic published by the St. Louis Fed measures the probability that the U.S. economy is currently in or near a recession. This measure keys in on the four components that make up the Coincident Economic Activity Index: 1) non-farm payroll employment, 2) industrial production, 3) real (inflation-adjusted) personal income, excluding transfer payments, and 4) real manufacturing and trade sales. This recession probability model is presented in Exhibit 4.

Exhibit 4: What Are the Odds?



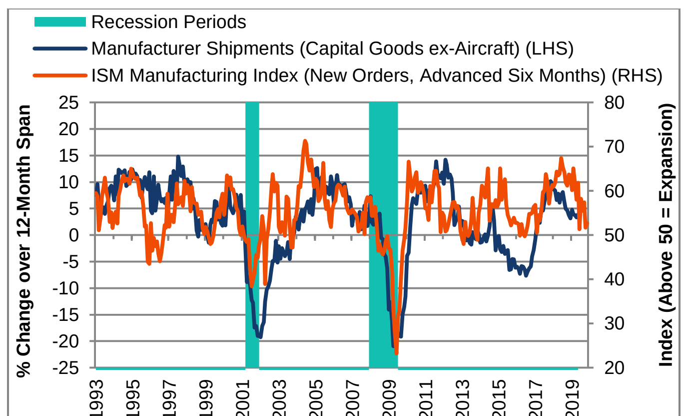
Source: Economic Cycle Research Institute, Federal Reserve Bank of St. Louis, SEI
Data as of 4/1/2019

Currently, the St. Louis Fed estimates only a 2.7% chance that the economy entered recession this past April (a statistically insignificant probability). Unfortunately, this measure does not provide much warning ahead of a downturn.

When the odds reach 10%, we think it pays to assume the worst—although there have been false positives, including one in 2005 and two during the late 1970s, which underscores the difficulty of anticipating an economic downturn well in advance. To quote another Nobel Prize winner, American novelist Ernest Hemingway wrote the following response for a character in *The Sun Also Rises* who was asked how he fell into bankruptcy: "Two ways. Gradually and then suddenly."[2] We think the same can be said for how the U.S. economy falls into recession.

To be sure, the U.S. economy is hardly firing on all cylinders at the moment (global business activity looks even soggier, especially in Europe). The key worry surrounds the manufacturing sector. In Exhibit 5, we track new-orders activity in the manufacturing industry (as published by the Institute for Supply Management, or ISM), and compare that to U.S. manufacturers' capital-goods shipments (excluding aircraft). As Exhibit 5 highlights, the rate of new orders leads that of manufacturers' shipments by about six months. Accordingly, we think there's a good chance that capital spending will continue to ease in the months ahead.

Exhibit 5: Don't Blame Boeing



Source: Census Bureau, Institute for Supply Management, SEI
Data as of 5/1/2019

At this point, though, we are not forecasting a major downturn in capital spending. In fact, as seen in Exhibit 6, gross residential investment in nominal-U.S. dollar terms, as measured in the GDP accounts, reached a new high during the first quarter; in real (inflation-adjusted) terms. The gain in business investment was even stronger because the price of computers and other high-tech goods tend to fall over time.

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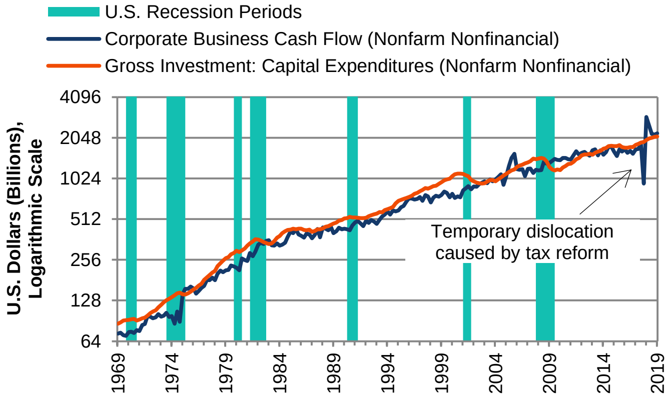
[2] Ernest Hemingway, *The Sun Also Rises*. New York: Scribner, 1926.

Exhibit 6: Investment Goes with the Cash Flow



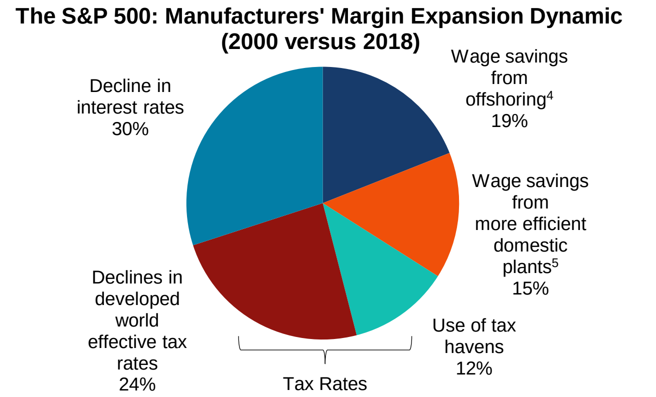
Source: ECRI, Federal Reserve Board, U.S. Bureau of Economic Analysis, SEI
Data as of 3/31/2019

Exhibit 6 also shows that corporate cash generation continues to run slightly ahead of capital expenditures. Corporate cash flows were unusually volatile in late 2017 and early 2018, owing to the impact of tax-reform and its effect on the repatriation of foreign earnings. The main point to remember: It's not unusual for capital expenditures to run well in excess of cash flow, especially toward the end of an economic up-cycle. And that's not happening yet.

Pessimists would argue that profits and cash-flow growth will come under increasing pressure in the year ahead. This is a legitimate concern. Exhibit 7 highlights the big drivers behind the huge margin expansion recorded by manufacturing companies in the S&P 500 Index between 2000 and 2018. Data from Empirical Partners[3] show that S&P 500 Index manufacturers enjoyed a large (and continuing) expansion in net profit margins over the 18-year period, from 6% in 2000 to a reading above 16%. The chart shows that 30% of the margin improvement was derived through the secular decline in interest rates. Falling effective corporate tax rates in the developed world and the use of tax havens provided 36% of the total expansion in net margins. Wage savings from offshoring and increased productivity of U.S.-based plants accounted for the remaining 34% of cumulative profit-margin expansion.

[3] Michael Goldstein, "Bretton Woods II: Hard to Kill," *Portfolio Strategy*, Empirical Research Partners, May 2019.

Exhibit 7: Changing at the Margins



Source: U.S. Bureau of Labor Statistics, U.S. Census Bureau, Corporate Reports, Empirical Research Partners Analysis, SEI
Data as of 12/31/2018

One could make the argument that most of these drivers have played themselves out. Interest rates are at extraordinarily low levels and likely have limited additional downside; if anything, rising corporate interest expense will probably lower margins in years ahead. Tax rates also are unlikely to move much lower.

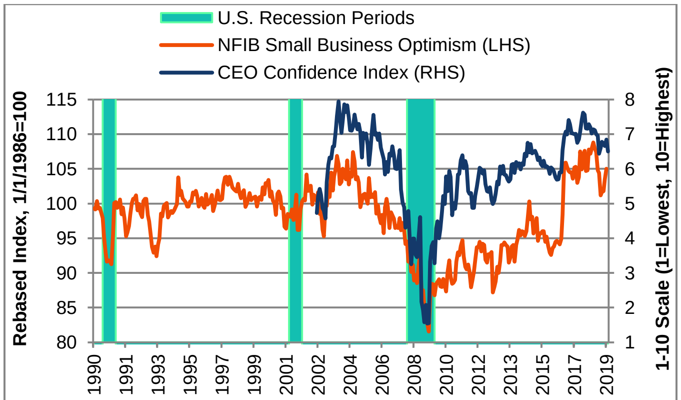
Governments are clamping down on the use of tax havens; they also are seeking ways to extract more tax revenues from companies that have managed to limit their taxable income through cost-shifting and transfer-pricing strategies (especially those in the information technology sector). Finally, wage savings from offshoring is expected to become a less important source of margin expansion, especially as government policies shift toward heightened trade protectionism. The only major source of profit-margin expansion that appears to remain is productivity improvement via capital deepening.

That being noted, U.S.-China tariff tensions and worries about global growth have put only a modest dent in the confidence of American businesses. Exhibit 8 highlights two different gauges of business optimism: The National Federation of Independent Business's (NFIB) survey of small businesses, and a monthly poll of American CEOs (the largest of its kind, which is conducted by an organization called the Chief Executive Group). Both measures are below their highs at present but appear consistent with continued economic expansion. The NFIB survey actually bounced higher in May despite the unexpected breakdown of talks between China and the U.S.

[4] Assumes that the lost U.S. jobs were replaced by jobs in China at lower rates of compensation.
[5] Assumes the decline in the labor intensity of these plants matches that for the entire U.S. manufacturing system.

A contrasting survey (not shown) from Business Roundtable, an organization whose members are chief executives of mainly large multinational corporations, had more pessimistic results. Its findings have bounced up and down quite sharply in recent years, making it seem less reliable than the broader surveys highlighted in Exhibit 8.

Exhibit 8: CEOs Say It's Not That Bad

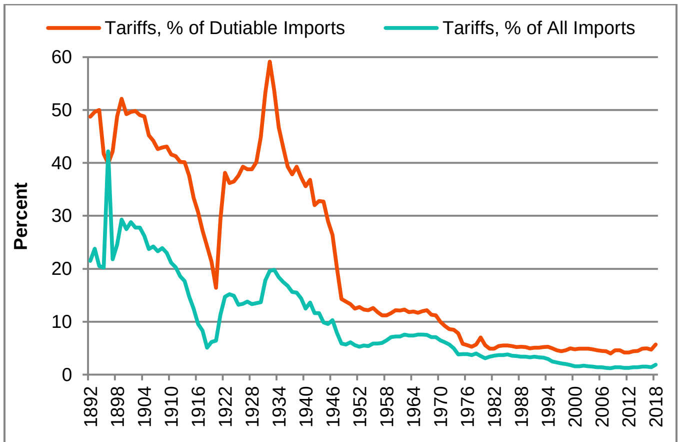


Source: Chief Executive Group, Economic Cycle Research Institute, National Federation of Independent Business (NFIB), SEI
Data as of 6/30/2019

The big unknown, of course, is how the evolving tariff war between China and the U.S. will affect U.S. economic growth and global trade in the months ahead. It certainly looks as if the U.S.-China trade relationship is quickly going from bad to worse, even though U.S. President Donald Trump and Chinese President Xi Jinping agreed at the G-20 summit to refrain from additional protectionist actions and keep negotiating. The Trump administration's blacklisting of Huawei, a Chinese telecommunication equipment company, caused the Chinese government to come up with its own blacklist of foreign companies (which has not yet been published). President Xi warned his country that China faces another "Long March" (the historic 6,000 mile trek of Chinese communists that resulted in their control of mainland China) in the country's economic confrontation with the U.S., while President Trump takes evident pleasure in calling himself "Tariff Man."

It is our view at SEI that the U.S. economy should be able to weather this storm. However, an all-out tariff war between the two largest economies in the world will certainly disrupt supply chains and likely lead to higher prices for a broad range of consumer goods, from cell phones and laptops to clothing, toys and sporting goods. Still, we think it helps to keep the problem in perspective. Even if the U.S. imposes a 25% tariff on all Chinese imports, total duties will amount to roughly $200 billion. That's the equivalent of 0.5% of U.S. GDP and about 8.5% of the present total value of merchandise imports. Exhibit 9 puts today's tariff war in historical context.

Exhibit 9: Not Your Great-Grandfather's Tariff War



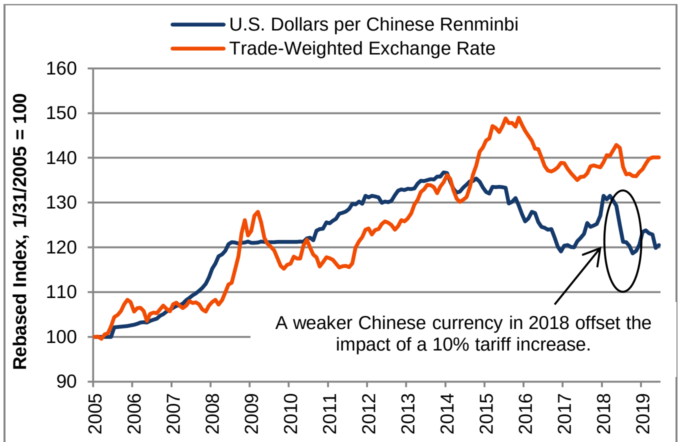
Source: U.S. International Trade Commission, SEI
Data as of 12/31/2018

It should be clear that this is not a repeat of the 1930s, when all major countries imposed tariffs on each other at much higher rates across a much broader array of goods. U.S. duties collected on imports in 2018 totaled nearly $50 billion, up from $33 billion in the previous year. That amounted to an average tariff rate of 5.7% and equaled only 1.9% of all imports (most products imported into the U.S. are not subject to tariffs). These percentages will move sharply higher through the rest of 2019 and in 2020 as the tariffs already imposed on China become fully incorporated. Take, for instance, the increased tariff rate from 10% to 25% on the $200 billion tranche of Chinese exports into the U.S. that was imposed in May. When implemented over a full 12 months, the additional tariff will boost the proportion of duties paid as a value of all imports to more than 4%—nearly double the current amount. Of course, the volume of Chinese imports into the U.S. will likely decline because these goods will be sourced from other countries wherever possible, thereby reducing the total duties collected.

It is not our intention to minimize the importance of the shift in U.S. trade policy toward protectionism. On the contrary, the Trump administration's hard-nosed approach to trade is quite an extraordinary development with long-lasting implications: National security considerations now trump economic ones for the first time since World War II. Investors must assume that the secular decline in tariff rates is over, but putting this shift in historical perspective should reduce the concern that the U.S. economy will fall off a precipice as a result of this change. Even in the event of full-fledged tariff assault on Chinese imports, the economic burden is well below that which prevailed during the 1920s and 1930s. At that time, duties as a percent of total imports averaged between 10% and 20%; actual tariff rates on dutiable goods were even steeper, reaching an all-time high of 59% in 1932.

We view the imposition of tariffs as a negative for growth, inflation and corporate profitability—yet it is not at all clear how much of a negative effect it will have. There are a lot of moving parts to consider. For example, China can devalue its currency in order to maintain its competitive edge. That tactic was used last year. As Exhibit 10 shows, the renminbi depreciated sharply against the U.S. dollar as the tariff war heated up. This action mostly offset the impact of tariffs that were imposed at that time.

Exhibit 10: Will China Be Forced to Manipulate Its Currency?



Source: JPMorgan Chase, WM/Reuters, FactSet, SEI
Data as of 6/30/2019

The Chinese currency strengthened against the U.S. dollar earlier this year as the trade negotiations appeared to be reaching a favorable conclusion. Following the breakdown in talks in early May, however, its value weakened again. While the ratio of seven renminbi to the U.S. dollar has been something of a line in the sand for the Chinese authorities, we do not expect it to hold as the country seeks ways to mitigate damage from the tariff war. If trade talks between China and the U.S. break down again and the Trump administration imposes more tariffs, a jump to seven-and-a-half renminbi per U.S. dollar is a distinct possibility as China employs depreciation to maintain its competitiveness.

China, however, can only depreciate its currency so far due to domestic financial stability concerns and because it would probably goad President Trump into hiking tariff rates even further. Fortunately, there are alternatives to devaluation. If a Chinese company (or China-based subsidiary of a multinational business) exports a much-desired consumer product or a critical intermediate component that cannot be substituted, the U.S. buyer will likely be forced to swallow the cost of the tariff. Of course, there are probably few goods that enjoy such unlimited pricing power. More likely, if a product enjoys a high profit margin, the importing company may instead absorb much of the extra cost.

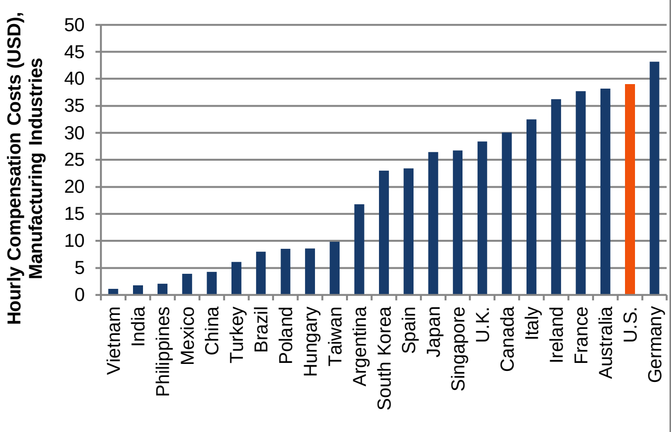
Low-tech goods with narrow profit margins (such as shoes and clothing) may need to be made elsewhere, in a low-cost locale like Vietnam, Bangladesh or Laos. That could have a severely negative impact on the Chinese economy since these labor-intensive industries employ millions of workers. The speed and ease with which supply chains can be relocated to other countries will be a critical factor, either exacerbating or tempering the tariff impact on consumers and companies in both the U.S. and China. It will depend on the complexity of the manufacturing process, the ability and educational level of the local workforce, and the available capacity and infrastructure of the potential host country. For example: Foxconn, a Taiwanese-based maker of Apple cellphones, recently announced that it has enough capacity outside China to satisfy demand.

An escalation of the trade wars by the U.S. against other countries would prove far more dangerous for the near-term growth prospects in the U.S. than if trade were disrupted only with China, Nevertheless, at the end of May, President Trump threatened to impose progressively higher tariffs on imports from Mexico unless the latter dealt aggressively with migrant caravans making their way to the U.S. border. Mexico quickly agreed to do more to stop the flow of asylum seekers, and the U.S. president rescinded his order.

This “win” for President Trump came at the cost of increased uncertainty for businesses. How does a manufacturer realign its supply chain away from China if an alternative country could be subject to higher tariffs at any time? President Trump’s decision to use the threat of tariffs in pursuit of his political goals will also likely disrupt business investment in other countries. Tariffs on German and Japanese autos are still a possibility later this year. We have been thinking that the U.S. would avoid waging multiple tariff wars as it concentrated its firepower on China—but this assumption may not hold. Our persistent optimism would be dealt a blow if President Trump continues to confront other countries through aggressive trade actions.

The U.S. president may want an American manufacturing employment renaissance, but this is an impractical goal. In Exhibit 11, we compare the wage rates of a broad selection of countries versus the U.S. Although the local wage rate is only one factor in deciding where to invest, many industries (textiles and apparel, shoes and less-sophisticated assembly processes) rank it among the most important. Along with other developed economies, the U.S. has high labor costs. Those costs can be covered only through a superior level of productivity and engagement in activities that add significant value.

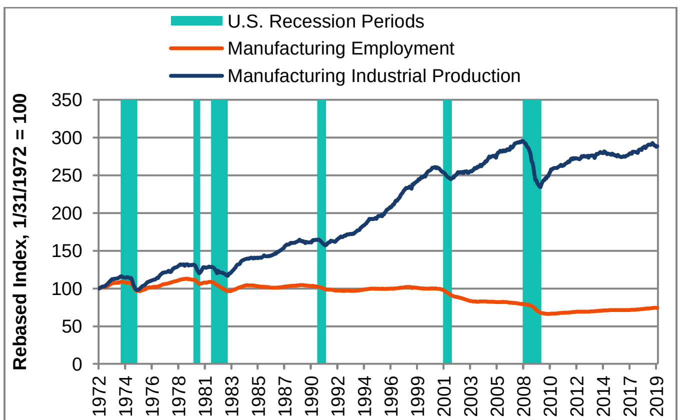
Exhibit 11: The U.S. Can't Wage a Wage War



Source: The Conference Board, Congressional Research Service, SEI
Data as of 12/31/2016

If manufacturing capacity does come back into the U.S., we do not expect a surge in employment. Rather, we expect a surge in robots and automated production processes. Exhibit 12 shows that manufacturing employment has stagnated since the 1970s. It fell sharply in absolute numbers over the last two decades as production moved to Mexico, China and elsewhere in Southeast Asia and Latin America. Meanwhile, industrial output of manufactured goods within the U.S. tripled over the twenty-year period as the remaining American workforce became more productive.

Exhibit 12: Manufacturing Production Doubles as Employment Contracts

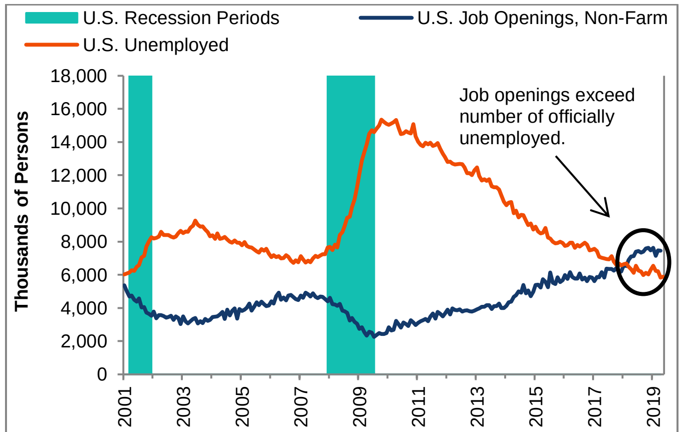


Source: Bureau of Labor Statistics, Federal Reserve Board, SEI
Data as of 5/31/2019

In our view, it would be a notable achievement if manufacturing jobs reached pre-2000 levels over the next 15 years. That represents a 2% per-annum rate of gain, which is a significant acceleration from the 1.3% annualized increase recorded since manufacturing payrolls began expanding again in 2010. But it would not be quite as surprising to see manufacturing output expand in excess of 5% per annum as technological progress remains in line with the sector's generally strong productivity growth of the past five decades.

Overall, we think the U.S. economy will show resiliency in the face of what is admittedly a stiff headwind. The decline in interest rates should certainly help consumers. Homebuilders have grown more optimistic (despite the drop in May home sales) with mortgage rates coming down. Retail sales have recently been stronger than expected. More broadly, household income growth has continued to advance at a good pace. There was a less-than-anticipated gain in payroll employment in May, but we do not think it should be cause for concern; the number of job openings exceeds the number of officially unemployed by a record amount, as shown in Exhibit 13.

Exhibit 13: Jobs Go Begging

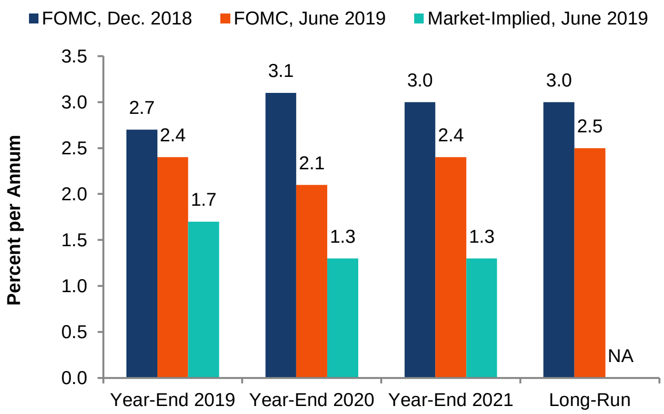


Source: U.S. Bureau of Labor Statistics, SEI
Data as of 5/31/2019

The Powell "Put" Lacks Patience

Fixed-income traders seem singularly focused on the trade battle and its potentially negative economic repercussions. Futures traders have driven the federal-funds-rate futures curve to well below the current policy rate of 2.25% to 2.50% on the expectation that future interest-rate cuts will provide support to stock prices—that is, the so-called "Fed put." In Exhibit 14, we compare the Federal Open Market Committee's (FOMC) interest-rate expectations (the median of the so-called dot plot that graphs member's rate projections) versus those of the market, as expressed in the federal-funds-rate futures curve. The market-implied rate (the green columns) projects a federal-funds rate of 1.7% by the close of 2019, consistent with three 25 basis-point cuts between now and the end of the year.

Exhibit 14: The Dot Plot Thickens



Source: Chicago Board of Trade, Federal Reserve Board, SEI
Data as of 6/30/2019

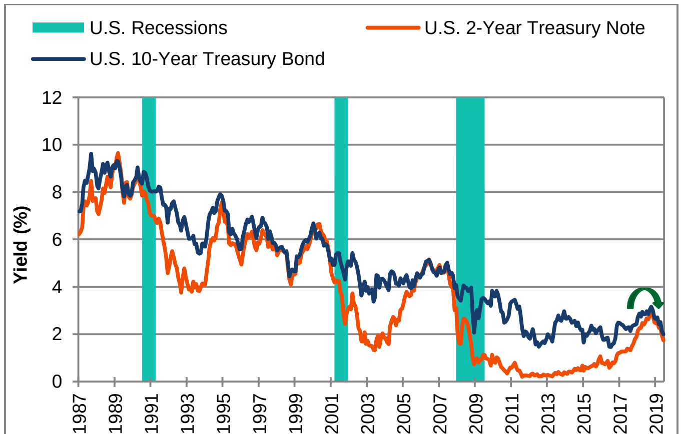
Although the forecasts of FOMC members have been more cautious, they are moving in the direction of the markets. Six months ago, members projected two more rate hikes in 2019 and another in 2020 (the first two dark blue columns). By the end of 2020, the federal-funds rate was expected to be above 3%. But just weeks after the December 2018 meeting, Fed Chairman Jerome Powell and his colleagues pivoted to a more dovish stance in response to signs of weakness in the global economy and the December collapse in stock and bond prices. The FOMC revised its policy rate expectations lower and promised to be "patient" in responding to the economic and inflation data.

The policymakers' most recent (June) median projection of the federal-funds rate (the red columns) represented a dramatic change from the FOMC's December survey. Rather than policy rate increases from the present 2.25% to 2.50% range, it now appears that there could be one rate cut by the end of this year followed by another cut next year. But in this case, the median forecast is highly misleading. Seven FOMC members think the Fed is likely to cut two times this year, while only one member is calling for a single reduction of 25 basis points. Of the remaining nine participants, seven see no reason to change the funds rate from its current range and one forecasts an increase. The dispersion among the member projections for 2020 is even wider. All of this is to say that there really is no FOMC consensus to actually cut the federal-funds rate. Before the Fed is prepared to move, either economic data must weaken further or trade talks with China needs to break down completely.

Who will be right, the Fed or the futures traders? This is not the first time there has been a huge disparity between what the Fed expects and what traders are betting will happen. In 2015 and 2016, FOMC members overestimated the number of times they would raise the funds rate. They ultimately implemented only two increases over this period, an outcome that was much closer to what the market implied at the time. In 2017 and 2018, by contrast, the central bank surprised market participants by doing what it said it was going to do: raise rates in a steady fashion.

The recent decline in bond yields to levels last seen in 2016 ranks as one of the biggest surprises of the year. The general expectation at the beginning of 2019 was for bond yields to drift higher; instead, as depicted in Exhibit 15, the 10-year benchmark bond plunged 70 basis points to 2% by the end of June. At the same time, the two-year note saw its yield fall by 80 basis points to 1.7%. We find it hard to justify these moves. In our view, recession is not likely without a severe policy mistake, such as fighting a tariff war on multiple fronts.

Exhibit 15: Yields Yield



Source: Economic Cyle Research Institute, FactSet, SEI
Data as of 6/30/2019

In this environment, SEI's U.S. equity portfolios remained dedicated to their value-tilted positioning. In our actively-managed large-cap funds, significant industry-sector overweights included financials, industrials and health care. Information technology, telecommunications and utilities were the most underweight. In the small-cap space, SEI's portfolios were taking a defensive stance, concerned by downward revisions in earnings and the extent of the slow patch in manufacturing. They were building up positions in companies that exhibited fundamental characteristics considered to be high quality (such as a high return on assets, high profit margins and strong solvency). Consumer staples were favored, while health care/biotech and energy stocks were underweighted.

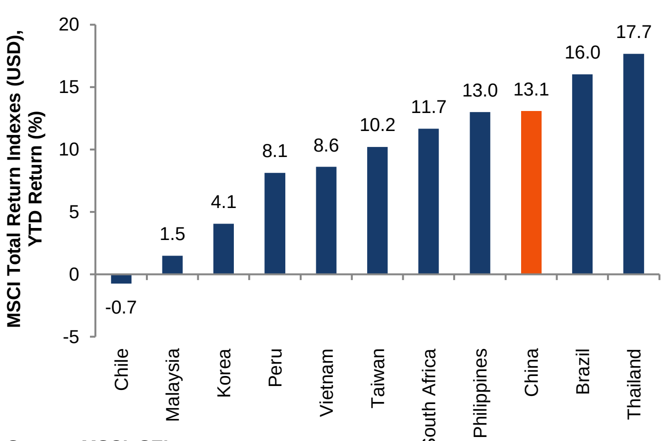
Within core fixed-income positions, SEI's portfolios allowed duration to drift back to a more neutral setting, from an overweight. Low growth and low inflation were the general macro themes from underlying portfolio positioning. Securitized sectors (asset-backed securities and commercial mortgage-backed securities) were overweight. Non-agency mortgages also contributed to performance. SEI's portfolios still favored bank securities primarily at the front end of the yield curve, a position that we expect to pay off if the yield curve steepens. In short- and limited-duration portfolios, duration was somewhat short of benchmark but the yield was higher.

There were few material changes in SEI's high-yield bond strategies. Our portfolios remained short duration and featured higher yields against the benchmark. Credit quality was in line with the index. Exposure to floating-rate bank-loans was maintained. Some underlying investment managers transitioned to a more defensive posture, however, following a June rebound for the asset class. One underlying manager decreased its exposure to CCC rated debt and increased exposure to BBB rated securities.

Emerging-Market Stocks Are Bulling Through

First the bad news: Emerging-market equities as represented by the MSCI Emerging Markets Index (total return) are lagging the U.S. stock market as represented by the MSCI USA Index (total return) for the year-to-date by about eight percentage points. Now the good news: The MSCI Emerging Markets Index (total return) has climbed 11% so far this year. When one considers all the headwinds facing emerging economies—a significant slowdown in Chinese economic growth, ongoing trade tensions between the U.S. and China, weak commodity pricing, and a still-resilient U.S. dollar—it's surprising that emerging stock markets have appreciated at all. In Exhibit 16, we highlight the performance of the MSCI China Index (total returns) in U.S. dollar terms and compare it against several countries that are critically dependent on China for its exports and/or because it is an integral part of their corporate supply chains.

Exhibit 16: It Could be Worse

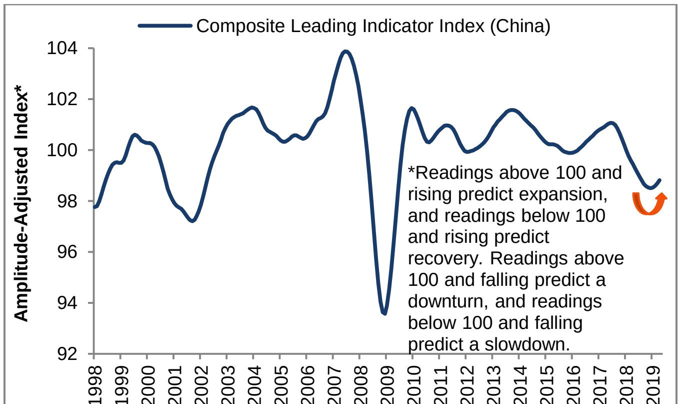


Source: MSCI, SEI
Data as of 6/30/2019

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

As long as a tariff truce remains in place with the U.S., we expect China's economy to improve in the months ahead. Scores of measures, both monetary and fiscal, have been put in place over the past year. They include value-added tax cuts, multiple reductions in banks' reserve-requirement ratios, new medium-term lending facilities, incentives to spur bank-lending to small private businesses and allowing local governments to issue special-purpose bonds to finance new infrastructure projects. Admittedly, the turnaround in economic growth up to this point is hardly overwhelming. One can see some early signs of improvement in the Organisation for Economic Co-operation and Development's Composite Leading Indicator (CLI) Index, as seen in Exhibit 17. Although still growing below trend, a trough appears to be in place as of April 2019. The components of this index include auto, steel and fertilizer production, overseas orders, total construction activity and stock prices. Autos, construction and stock prices have been the main drivers of the recent improvement.

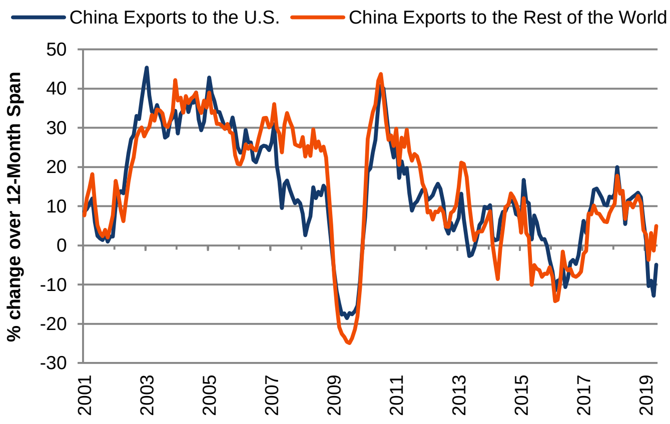
Exhibit 17: China Taking the Lead?



Source: Organisation for Economic Co-operation and Development, SEI
Data as of 4/30/2019

The tariff war with the U.S., however, is having an impact. China's official manufacturing purchasing managers index (a measure biased toward larger, state-owned enterprises) remains weak, once again falling into contraction (below 50) in June. As Exhibit 18 shows, the year-over-year change in exports to the U.S. moved into negative territory earlier this year. The decline so far is comparable to the 2015-to-2016 experience, but is likely to worsen as the latest round of tariff hikes feed into the statistics. The percentage change in total exports to the rest of the world rebounded in May.

Exhibit 18: Tariffs Take Their Toll



Source: China Customs, SEI
Data as of 5/31/2019

In response to the trade tensions, SEI's emerging-market portfolios repositioned their portfolios to gain additional exposure to domestically-oriented stocks. Overall, they remain bullish on the asset class owing to the secular trend of an emergent or expanding middle class in many of these countries. Although value stocks are becoming more attractive relative to momentum and stability, our portfolios remained neutrally positioned toward the factor. From an industry-sector perspective, financials, materials and real estate represented the largest underweights in the portfolio. Overweight positions were in telecommunications, industrials and information technology. Regionally, our portfolios were underweight Asia, Africa and the Middle East relative to the benchmark. Latin America was overweight.

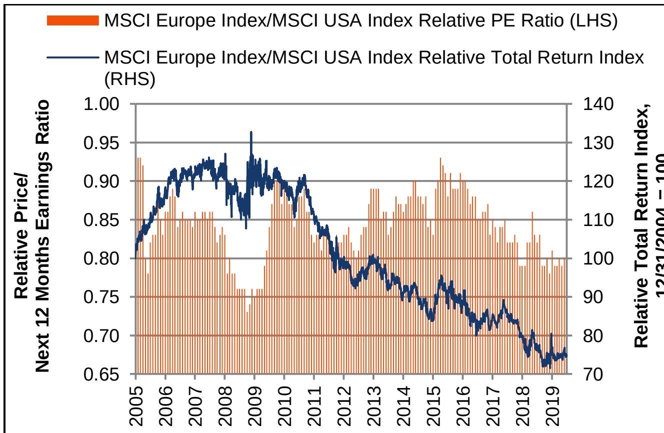
SEI's emerging-market bond portfolios eliminated their overweight position to local-currency debt and their underweight position to hard-currency debt. Argentina and Egypt remained key risk positions, but our portfolios moved to limit overall exposure. They recently moved from a neutral to overweight China position versus the benchmark. Although tariff tensions have not been a positive development, we believe they will force the People's Bank of China to support the economy. Financial conditions are easing in several emerging economies, as central banks in those countries take advantage of currency stability and the downward shift in developed-market policy rates. We note that Turkey's central bank cut its policy interest rate in dramatic fashion, from 24% to 16%, owing to political pressure exerted by President Recep Tayyip Erdogan.

Our Japan-based portfolios have been positioned on the assumption that a truce in the tariff war would occur. As a result, they have stayed the course despite increased equity volatility since early May. Consumer discretionary, financials and energy were overweight positions. Underweights included consumer staples, healthcare and utilities.

Europe: A Glimmer of Dark Amidst Rising Gloom

It has been a long, lost decade for investors in European equities—at least when juxtaposed against the performance of U.S stocks. In Exhibit 19, we compare the relative total return of the MSCI Europe Index (including the U.K.) versus the MSCI USA Index (total return). European stocks actually outperformed the U.S. in the run-up to the 2008 global financial crisis, but have lagged badly for the past 10 years. The price-to-forward earnings ratio of the companies that make up the MSCI Europe Index, meanwhile, also has fallen sharply versus the forward price-to-earnings ratio of the MSCI USA Index. As recently as 2015, European stocks traded at only a 7% discount to the U.S. Since then, the relative price-to-forward earnings discount has widened to 20%.

Exhibit 19: Poor Relatives



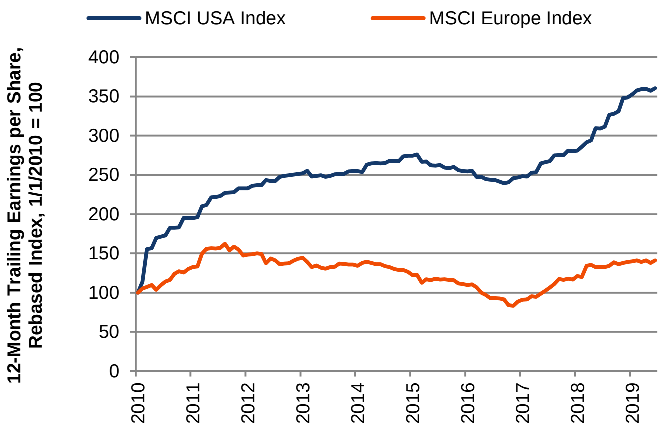
Source: MSCI, SEI
Data as of 6/30/2019

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

There are good reasons for this poor relative performance. First, economic growth has been superior in the U.S. since the beginning of 2009, with U.S. inflation-adjusted GDP rising a cumulative 25% versus a gain of only 16.5% for the EU as of the second quarter of 2019. The differential in profitability is even starker: The earnings per share of the MSCI USA Index have climbed a cumulative 250% since 2010, on a 12-month trailing basis as of June 30, 2019. In contrast, the comparable rise in trailing earnings per share for the MSCI Europe Index is less than 40%.

Remarkably, as Exhibit 20 highlights, trailing earnings for the MSCI Europe Index are currently lower than the level recorded in 2011.

Exhibit 20: A Lost Decade for European Profits



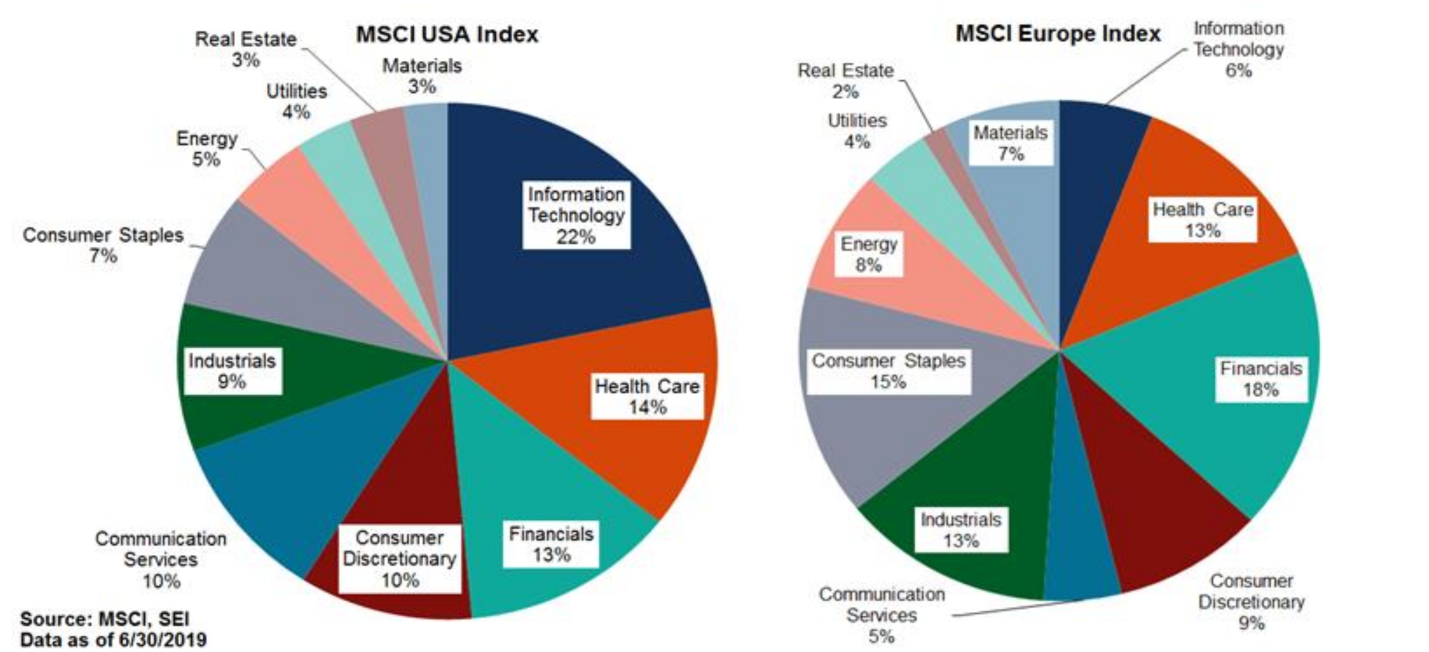
Source: MSCI, SEI
Data as of 6/30/2019

The disparity in profits growth stems in large part from the composition of the equity indexes. In essence, Europe is one big value stock. As shown in Exhibit 21, the MSCI Europe Index is weighted heavily toward financials, consumer staples and industrials. Information technology totals just 5.8% of the benchmark's weight versus of 21.7% in the MSCI USA Index, where it is the largest sector. Energy and materials together account for 15.3% of the MSCI Europe Index capitalization, which is more than twice the combined weighting found in the MSCI USA Index.

Despite trailing the U.S. for ten years, no trend lasts forever. There will come a time when Europe again outperforms the U.S. for an appreciable period, just as value investing more generally will outperform growth investing. In a recent report published by SEI, *U.S. Value Stocks: Why We Still Love Them*, we cited some of the potential catalysts that could lead to an improvement in relative performance of value-oriented strategies—including rising interest rates and widening yield-curve spreads that would benefit banks and other financial intermediaries; faster economic growth and an increase in inflation (especially helpful for commodity-producing sectors); and a failure of technology stocks to meet the lofty expectations of investors.

It's not certain, though, when or which of these catalysts will fall into place. Indeed, Europe currently faces a variety of idiosyncratic challenges, both economic and political, that make it hard for even contrarian investors to get terribly enthusiastic about the near term. Economically, there is no question that the region is going through another soft patch.

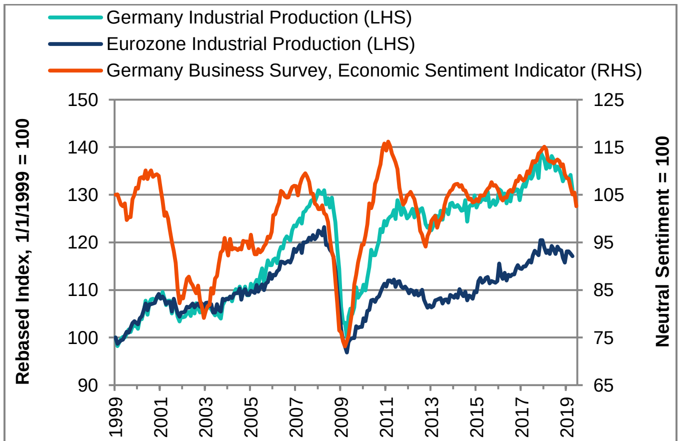
Exhibit 21: The Source of the Problem



Source: MSCI, SEI
Data as of 6/30/2019

In Exhibit 22, we show that industrial production has been easing across the eurozone since the end of 2017. The downward trajectory is similar to that of the 2011-to-2012 period amid the region's periphery debt crisis. This time, however, Germany's industrial economy is fully participating in the European slowdown.

Exhibit 22: Germany Feels the Angst



Source: Eurostat, Statistics Germany, SEI
Data as of 4/30/2019

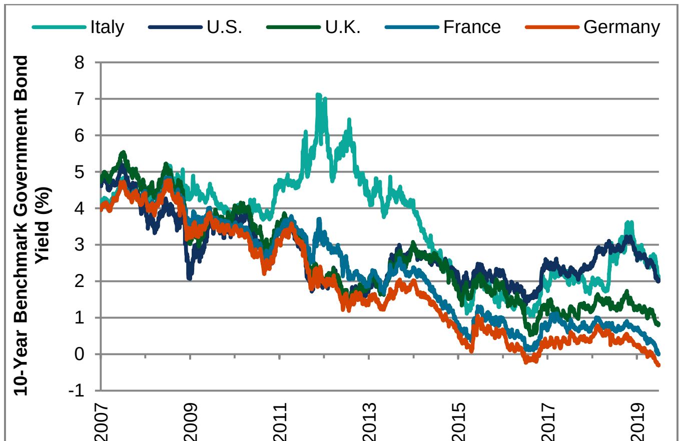
Although the slowdown in global trade is a factor, the main problem for Germany is homegrown. The country's industrial production of consumer goods collapsed last year due to a diesel-engine emissions scandal. There is reason to think that the worst might be in the past: Vehicle registrations in Germany have picked up lately, showing better-than-seasonal growth. Consumer spending popped higher in the first quarter, pushing annualized GDP growth to a 1.7% rate measured on a quarter-over-quarter basis. That was slightly better than the eurozone average. Business sentiment in the country nevertheless remained depressed. The German consumer may be coming back a bit, but capital goods orders continued to slump.

Economic growth in the eurozone as a whole continues to grow. Granted, the expansion has been slow, only running slightly better than 1% in 2019 (as of June 30). That's less than half the pace expected in the U.S. In any event, it's not just the region's heavy exposure to manufacturing and international trade that makes German industrialists glum. There is also a worrisome vacuum of political leadership. Chancellor Angela Merkel is on her way out, sharpening the battle for power between the left and right at the expense of the center. While this is not just a problem unique to Germany or the Continent, a politically distracted Germany is concerning given the country's central importance in the eurozone and EU.

At the supra-national level, Germany's Ursula von der Leyen has been nominated to serve as president of the European Commission (the executive arm of the EU) and Christine Lagarde of France (the current president of the International Monetary) will succeed Mario Draghi as European Central Bank (ECB) President at the end of October. Lagarde is expected to maintain her predecessor's dovish policies. Perhaps before Draghi leaves office, we will see another interest-rate cut that brings policy rates deeper into negative territory. A new round of quantitative easing, beginning just as the current one is set to end, cannot be ruled out either.

As in the U.S., the markets seem to be forcing the central bank's hand. Bond yields are falling across the board. As illustrated in Exhibit 23, German 10-year bunds fell to a new low of -0.30% per annum at the end of the second quarter. Italian bonds, meanwhile, declined to a yield of 2.08%, less than 10 basis points above that of comparable U.S. Treasurys as of June 30. Even Greek bond yields retreated to 2.40%, down from a crisis high of 34% in 2012. As in the U.S., there is an expectation that the ECB will do whatever it takes to inject liquidity into the markets.

Exhibit 23: Bond Yield Bonfire



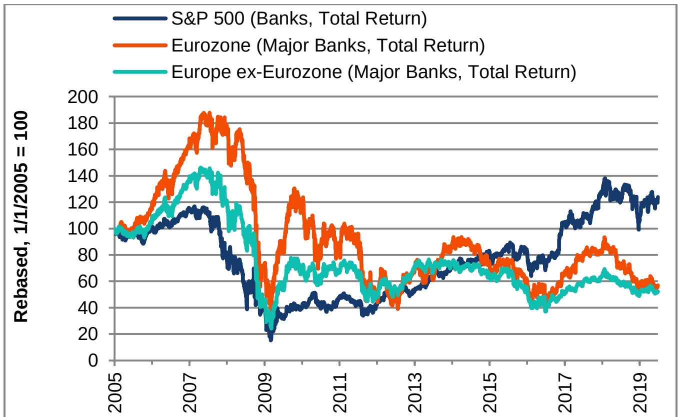
Source: FactSet, SEI
Data as of 6/30/2019

President Draghi has reason to be concerned. Europe remains stuck in an economic rut. As Germany slows, it's hard for other countries to take up the slack. Unconventional monetary policy in the form of negative interest rates, quantitative easing and term lending facilities do not carry a lot of punch nowadays.

An aggressive easing of fiscal policy makes sense from a Keynesian economist's perspective (named for British economist John Maynard Keynes), on the premise that increased government spending will bolster aggregate demand. But that strategy is a non-starter in the eurozone. Germany and other northern economies may have the fiscal room to ease but they do not have the political desire. The countries that desperately need and want a looser fiscal policy, notably Italy, do not have the legal room to do so. Once again, the structural flaws of the eurozone are coming to the fore. There is no formal mechanism to transfer wealth from richer to poorer countries, as there is among the states in America.

Nor is there an easy way to properly bail out and reform the banking system. As seen in Exhibit 24, investors have bid up the shares of U.S. banks back to where they were before the financial crisis. Europe's banks remain near the lows reached 10 years ago, a reflection of their inability to adequately recapitalize themselves or remove the bad debt that is on their books.

Exhibit 24: Investors Are Not Banking on Europe



Source: FactSet, S&P, SEI
Datasets refer to FactSet industy groups
Data as of 6/30/2019

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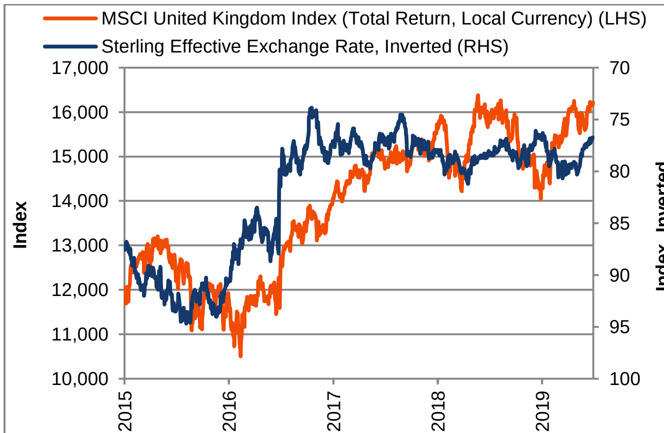
And then there's the looming cloud of Brexit. Although the Brexit date has been delayed until October 31 (ECB President Draghi must be relieved he won't be around to deal with the issue), there is little sign that the breathing space will be put to good use. The U.K. Conservative Party's search for a new prime minister will take a few more weeks to be resolved. It appears likely, however, that Boris Johnson will be the winner. It's hard to see how that improves the chances of an orderly exit. Perhaps there will be another mighty kicking of the can down the road, but we don't think that investors should count on it.

Although economic growth is sluggish, the U.K. economy is not exactly cratering as the deadline approaches. In fact, the unemployment rate fell to a multi-decade low in June, tracing the same downward trajectory as the U.S. headline measure. The eurozone also recorded steady labor-market improvement; although the jobless rate itself remained far higher, owing to structural factors like restrictive labor laws and the high marginal cost of adding to payrolls.

That said, we can't help but think Brexit (if it indeed occurs) will prove to be a highly disruptive event for the U.K. and the EU. Roughly half of the U.K.'s trade in goods, both imports and exports, is with the EU. Trade in both directions fell sharply in April. Some of this weakness probably could be blamed on the general weakening of the European manufacturing sector. It also reflects the unwinding of earlier inventory building as companies raced to beat the prior Brexit deadline of March 31.

Given all this uncertainty, it's a bit surprising that U.K. equities have been trading near their previous high-water mark, as seen in Exhibit 25. The depreciation of the pound since early May probably has helped to lift the stock market, since exporters compose such a large part of the market's capitalization. In the event of Brexit, a further drop in sterling probably should be expected. Most currency watchers, however, believe that it is already undervalued to a significant degree. If Brexit is again delayed, the pressure on sterling would be toward the upside instead—particularly if the Bank of England leans against the upward wage and price pressures that have been building. England's central bank has held its policy rate steady this year, not wanting to roil financial markets as the Brexit drama plays out. We will see how the situation resolves itself in the months ahead.

Exhibit 25: A Cheap Pound Helps U.K. Equities



Source: Bank of England, MSCI, SEI
Data as of 6/30/2019

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SEI's global equity portfolios continued to have a value bias. Financials, consumer discretionary and industrials remained favored sectors, while information technology and consumer staples were the most underweighted. SEI believes that the Fed's tightening cycle is done. Global central banks are expected to follow the U.S. central bank down a dovish path. SEI's fixed-income portfolios were overweight credit, maintaining a pro-cyclical bias toward the U.S., U.K. and Europe. Within spread sectors, non-agency mortgage-backed securities were favored over corporates. Despite increased odds of a hard Brexit and a chance that the Conservative government will fall (resulting in a general election), our portfolios were overweight sterling because of its severe overvaluation on a fundamental basis.

Glossary

Basis point: One basis point equals 0.01%.

Breakeven inflation refers to the average annual rate of inflation over the term of an inflation-indexed bond that would provide the same return as a non-inflation indexed bond. It is calculated by taking the difference between the nominal yield of a conventional Treasury bond and the real yield of an inflation-linked Treasury bond of the same maturity.

Cash flow per share is a measure used to gauge a company's financial strength and is calculated by its per-share after-tax earnings plus depreciation.

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.

France 10-Year Bond is a government bond issued by France and denominated in its own currency with a 10-year maturity. Bonds issued by national governments in foreign currencies are normally referred to as sovereign bonds.

Germany 10-Year Government Bund is a government bond issued by Germany and denominated in its own currency with a 10-year maturity. Bonds issued by national governments in foreign currencies are normally referred to as sovereign bonds.

Greece 10-Year Bond is a government bond issued by Greece and denominated in its own currency with a 10-year maturity. Bonds issued by national governments in foreign currencies are normally referred to as sovereign bonds.

Idiosyncratic refers to characteristics that are unique or specific to a person or entity.

Momentum refers to the tendency of assets' recent relative performance to continue in the near future.

Price to earnings ratio (P/E): The P/E ratio is equal to a company's 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.

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.

Stability refers to the tendency of low-risk and high-quality assets to generate higher risk-adjusted returns.

United Kingdom 10-Year Bond is a government bond issued by the United Kingdom and denominated in its own currency with a 10-year maturity. Bonds issued by national governments in foreign currencies are normally referred to as sovereign bonds.

Value refers to the tendency of relatively-cheap assets to outperform relatively-expensive assets.

Index Definitions

Bloomberg Barclays Global German Bond 7-10 Year Index: The Bloomberg Barclays German Bond 7-10 Year Index is comprised of generic German government bonds with fixed maturities between 7 and 10 years.

Bloomberg Barclays U.S. Short Treasury Index: The Bloomberg Barclays U.S. Short Treasury Index tracks the market for treasury bills issued by the U.S. government. U.S. Treasury bills are issued in fixed maturity terms of 4-, 13-, 26- and 52-weeks. The U.S. Treasury Bill Index is a component of the U.S. Short Treasury Index along with U.S. Treasury notes and bonds that have fallen below one year to maturity.

Bloomberg Barclays U.S. Treasury 10-Year Bond Index: The Bloomberg Barclays U.S. Treasury 10-Year Bond Index is a benchmark index composed of U.S. Treasury bonds designed to measure the performance of long-term maturity fixed-income securities.

CEO Confidence Index: The CEO Confidence Index is based on America's largest monthly survey of chief executives. Chief Executive Group polls CEOs across corporate America, at organizations of all types and sizes.

China's National Bureau of Statistics official manufacturing PMI: China's official manufacturing PMI measures the performance of the country's manufacturing sector and is biased toward larger, state-owned enterprises.

China's Purchasing Managers' Index: China's Caixin Manufacturing Purchasing Managers' Index measures the performance of the country's manufacturing sector, based on a survey of 430 private industrial companies.

Coincident Economic Activity Index: The Coincident Economic Activity Index includes four indicators: nonfarm payroll employment, the unemployment rate, average hours worked in manufacturing and wages and salaries. The trend for each state's index is set to match the trend for gross state product.

Institute for Supply Management (ISM) Manufacturing Purchasing Managers' Index (PMI): The ISM Manufacturing PMI is a widely-watched indicator of recent U.S. economic activity. Based on a survey of purchasing managers at more than 300 manufacturing firms, it monitors changes in production levels from month to month.

MSCI ACWI Index: The MSCI ACWI 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.

MSCI Brazil Index: The MSCI Brazil Index is designed to measure 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 Chile Index: The MSCI Chile Index is designed to measure performance of the large- and mid-cap segments of the Chilean market.

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 the 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 Index: The MSCI Europe Index is part of the Modern Index Strategy and represents the performance of large- and mid-cap equities across 15 developed countries in Europe. The Index has a number of sub-indexes that cover various sub-regions, market segments/sizes and sectors, and covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Korea Index: The MSCI Korea Index is designed to measure the performance of the large- and mid-cap segments of the South Korean market. With 114 constituents, the Index covers about 85% of the Korean equity universe.

MSCI Malaysia Index: The MSCI Malaysia Index is designed to measure the performance of the large- and mid-cap segments of the Malaysian market. With 43 constituents, the Index covers about 85% of the Malaysian equity universe.

MSCI Peru Index: The MSCI Peru Index is designed to measure the performance of the large- and mid-cap segments of the Peruvian market. With three constituents, the Index covers approximately 85% of the Peruvian equity universe.

MSCI Philippines Index: The MSCI Philippines Index is designed to measure the performance of the large- and mid-cap segments of the Philippines market. With 23 constituents, the Index covers about 85% of the Philippines equity universe.

MSCI South Africa Index: The MSCI South Africa Index is designed to measure the performance of the large- and mid-cap segments of the South African market. With 47 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in South Africa.

MSCI Taiwan Index: The MSCI Taiwan Index is designed to measure the performance of the large- and mid-cap segments of the Taiwan market. With 87 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in Taiwan.

MSCI Thailand Index: The MSCI Thailand Index is designed to measure the performance of the large- and mid-cap segments of the Thailand market. With 37 constituents, the Index covers about 85% of the Thailand equity universe.

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 Vietnam Index: The MSCI Vietnam Index is designed to measure the performance of the large- and mid-cap segments of the Vietnamese market. With 16 constituents, the Index covers approximately 85% of the Vietnam equity universe.

MSCI World ex-USA Index: The MSCI World ex-USA Index is designed to measure the performance of the large- and mid-cap segments of 22 out of 23 developed-market countries (not including the U.S.) and 24 emerging-market countries.

OECD Composite Leading Indicator Index (CLI): The OECD CLI is used to measure turning points in the business cycle. The metric looks at qualitative data on short-term economic movements. It is used to predict the direction of global economic movements in future months and is published by the Organisation for Economic Co-operation and Development.

Purchasing Managers' Index (PMI): The PMI is an indicator of economic health for manufacturing and service sectors. Its purpose is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

S&P 500 Financials Sector: The S&P 500 Financials Sector is made up of stocks in the S&P 500 Index that are categorized as members of the financials sector.

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, including 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.

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There are risks involved with investing, including loss of principal. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Narrowly focused investments and smaller companies typically exhibit higher volatility. Bonds and bond funds will decrease in value as interest rates rise. High-yield bonds involve greater risks of default or downgrade and are more volatile than investment-grade securities, due to the speculative nature of their investments.

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

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