# Economic Outlook

Fourth Quarter 2017

## Dancing Days for the Global Economy and Financial Markets

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- 2017 was another good year for the global economy and financial markets.
- We have been bullish for most of this long bull run and maintain our positive outlook for the New Year.
- We may see the return of some market volatility, which we would view as a normal development.

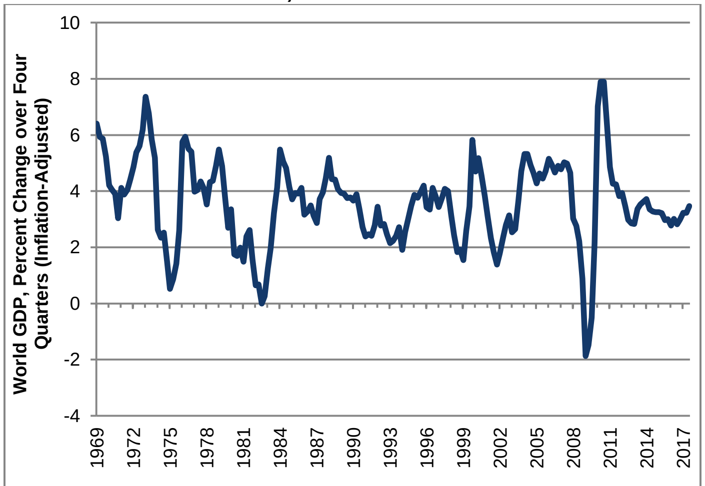
*I said it's alright/you know it's alright*
-Led Zeppelin, "Dancing Days," *Houses of the Holy*, Atlantic Records, 1973.

Classic rock fans will know what I mean when I say that global economies and financial markets "got the Led out" in 2017. For those of you less familiar with the music of Led Zeppelin, we can sum up the year gone by with the exclamation that, at long last, the global financial crisis finally appears to be in the rear-view mirror. In its place is a synchronized expansion across most developed and emerging economies, including the third longest in U.S. history. With almost 70% of the countries and regions tracked by the Organisation for Economic Co-operation and Development (OECD) showing rising readings in its composite index of leading economic indicators as of October (the latest available data), above-trend growth is implied. Just as impressive, three quarters of the countries and regions tracked have enjoyed improvement in the pace of growth on a year-over-year basis. Purchasing managers echo this overwhelmingly positive trend. Out of 37 advanced and emerging-market countries surveyed in December by IHS Markit, only two (Israel and South Africa) flagged a contraction in their manufacturing sectors.

Growth in world gross domestic product (GDP) ticked higher during the first three quarters of 2017, as shown in Exhibit 1. Even the most pessimistic forecasters now concede that the improvement in economic activity continued through the end of 2017, perhaps resulting in a full-year gain in world GDP of 3.75% in inflation-adjusted terms. Given the broad strength of the OECD's leading economic indicators cited above, world GDP growth in 2018 should be greater than 4%. Yet this improvement needs to be placed in perspective: developed economies continued to run at a rather sluggish pace of 2% to 2.5%.

This is, at best, a middling sort of performance in the context of the past five decades. Emerging-market economies, meanwhile, continued to expand at a clip well below that of the past 20 years—a period during which globalization and China's re-integration into the world economy drove developing-world growth.

**Exhibit 1: Good Times, Bad Times**



Source: International Monetary Fund, SEI

We don't expect global growth to soon return to the high rates recorded prior to 2007. The aging population throughout the developed world and in middle-income Asian economies like China and South Korea will constrain the pace of growth in the years ahead. In addition, the globalization boom, while not exactly a one-off phenomenon, was certainly boosted by the economic ascension of China and the creation of supply chains across a wide spectrum of emerging economies. These relationships have entered a more-mature stage. They are also now under threat by U.S. President Donald Trump's administration and the governments of other countries where politics have similarly taken an anti-establishment, anti-globalist turn.

These longer-term considerations, however, do not preclude additional economic strengthening in the near term. Over the next year or so, we think global growth can still be vibrant enough to allow risk assets to perform well. Financial markets and the global economy may not be on a stairway to heaven, but there is no reason to expect them to crash like a lead zeppelin.

**The Song Remains the Same in the U.S.**

This time last year, we were relatively upbeat about the economic prospects of the U.S. We thought the incoming Trump administration would act quickly to push through a variety of initiatives aimed at putting a spark into business activity. With regard to tax reform, we expected a reduction in the top statutory corporate tax rate to as low as 20% (the administration at that time was calling for a 15% top rate). Beginning January 1, the statutory top rate will drop to 21%. A repatriation holiday also is in the package, which should coax money held abroad back into the U.S. We also speculated that Congress would be willing to increase the deficit in order to achieve buy-in for individual and small business tax cuts in exchange for the elimination of certain popular deductions. This has come to pass, with severe limitations imposed upon state and local tax deductions offset by lower tax rates, a higher standard deduction and a much higher income threshold at which the universally hated Alternative Minimum Tax takes effect (the latter will be completely eliminated for corporations).

The legislation, a product of horse-trading among Republicans, is hardly perfect. Many individual tax changes will revert in 2025 to previous law unless extended by a future Congress. Nor will the tax package be as stimulative as advertised, since tax cuts are skewed toward upper-income tax payers who tend to have a higher saving rate than the median household. But the permanent corporate tax changes and the full expensing of capital equipment purchases over the next five years are positive developments for economic growth and investment.

Beyond tax-related considerations, we also saw deregulation and the reversal of Obama-era executive orders as top agenda items. We correctly anticipated that infrastructure spending would be placed on the back burner (although it could become a hotter topic in 2018). Trade issues, meanwhile, were an area of deep concern this time last year. Although the Trans-Pacific Partnership agreement was quickly thrown out of consideration by President Trump, as we had expected, the fight to “fix” the North American Free Trade Agreement (NAFTA) and gain a better deal with China and South Korea has proceeded at a more deliberate pace than feared. Since the jury is still out regarding the critical issue of trade developments in the year ahead, the situation will need to be watched.

One forecast that now looks naïve in retrospect was that the long era of political gridlock in Washington would end. Resistance to the Trump agenda by the “loyal” opposition was much fiercer than expected, with Democratic senators holding surprisingly firm. Republicans, meanwhile, have had difficulty showing the same level of internal discipline, outside of the recently passed tax legislation. This was highlighted most dramatically by the failure to repeal, replace or modify the Affordable Care Act last March (at least until the ACA’s individual mandate was scrapped as part of the tax legislation).

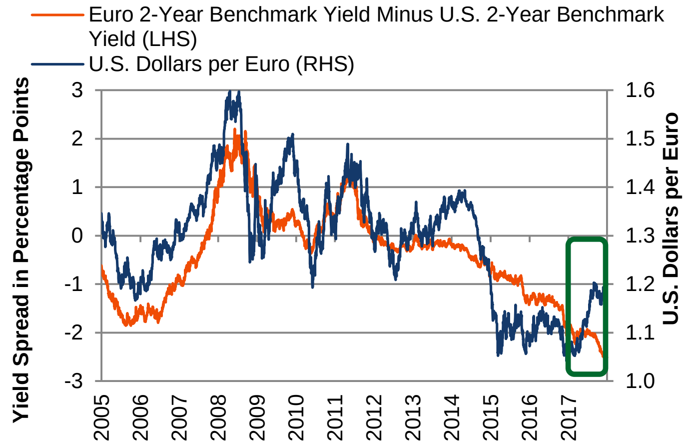
Of course, President Trump did not do himself any favors. Travel bans, Twitter storms, fights with fellow Republicans, escalating tensions with North Korea and significant personnel shuffles within the White House highlighted a chaotic first year that distracted from the administration’s agenda, limited legislative progress and deepened partisan ill will. Looking back on the first year of the Trump presidency, we would not blame anyone for feeling dazed and confused.

Fortunately, political dysfunction did not derail the U.S. economy or the financial markets. Inflation-adjusted GDP grew an estimated 2.6% over the four quarters of 2017, up from 1.8% in 2016. The two most recent quarters have recorded an even quicker annualized pace of greater than 3%. Inflation pressures, meanwhile, have remained muted. This economic performance was more or less in line with our expectations at the start of last year. SEI also took the Federal Reserve (Fed) at its word; namely, that the central bank would raise the federal funds rate three times in 2017. We thought that Treasury bond yields would stay below 3%. As it turns out, the benchmark 10-year Treasury bond ended the year close to where it started. The intra-year fluctuations were modest.

One major development we did not forecast was the notable weakness of the U.S. dollar against other currencies. We figured the Fed was much further along the path of interest-rate normalization than other central banks, and that the large interest-rate differential in favor of U.S. fixed-income securities would continue to bolster the greenback. But, as seen in Exhibit 2, the widening rate spread no longer seems to be a driver of the currency’s value.

**Exhibit 2: The Euro Surprises to the Upside**



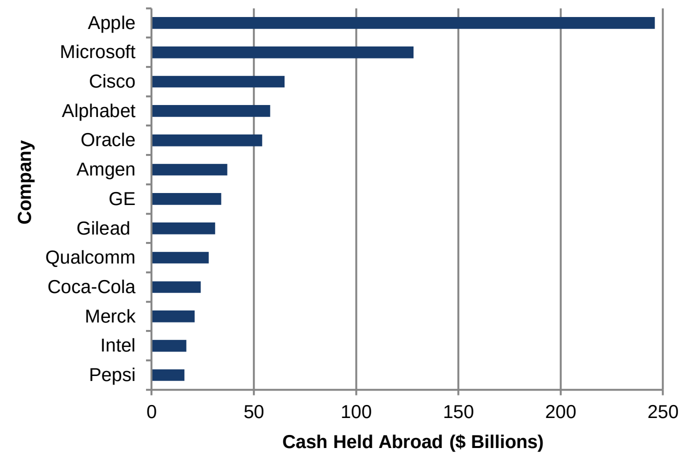

**Source: Tullet/Prebon Information, WM/Reuters, FactSet, SEI**

One outcome of the U.S. dollar's drop has been a sharp improvement in profits for U.S. exporters. Year-on-year gains in trailing earnings through the third quarter totaled 14.1% for S&P 500 Index (Total Return) companies that derive the majority of their earnings abroad; meanwhile, trailing revenues advanced by 8.3%, according to data supplied by Credit Suisse market strategist Jonathan Golub. Companies with a domestic focus, by contrast, logged respective revenue and earnings gains of only 3.8% and 8.5%. As anticipated at the beginning of the year, energy-company earnings logged the greatest percentage change as they recovered from exceptionally depressed levels. Technology provided the bulk of the profits in aggregate, however, given the sector's large capitalization. Financials also enjoyed solid earnings in 2017, excluding hurricane losses. In all, S&P 500 Index trailing revenues grew by 5.7% year-over-year through the third quarter, better than the 4.2% rise in nominal GDP. Total S&P 500 Index trailing earnings advanced by 8.1% and earnings per share (EPS) climbed by 9.4%. For all of 2017, S&P 500 Index operating EPS should exceed 10%.

Security analysts, always an optimistic lot, are calling for an 11% rise in per-share operating earnings in 2018. Although earnings estimates tend to fade through the year as they adjust to reality, this time may be an exception because tax cuts have not yet been taken fully into account. Whatever the outcome, it cannot be denied that analysts have been raising their sights. Earnings estimates on a 12-month forward basis have increased by 10.1% over the past year and are 17.9% above the low recorded in February 2016.

The tax-reform package will also give companies the opportunity to repatriate funds abroad at an advantageous tax rate. Publicly traded companies currently hold more than $2.5 trillion in foreign jurisdictions. Exhibit 3 highlights the fact that this cash hoard is concentrated in the largest U.S. multinational companies.

**Exhibit 3: Bring It on Home**




**Source: Company reports, SEI**

The 13 companies listed in the chart above hold an aggregate $760 billion overseas. A survey conducted earlier in the year by Bank of America Merrill Lynch found that nearly two-thirds of reporting companies would use repatriated funds to pay down debt. Almost half of respondents (46%) would buy back their own equity, thereby boosting EPS. Companies also cited mergers and acquisitions, capital spending and dividend increases as popular uses for repatriated funds. These are mostly shareholder-friendly actions and support the view that one shouldn't fight the bullish trend in equities.

The major worry for investors comes down to the stock market's valuation. Exhibit 4 compares the S&P 500 "price-only" Index against different price-to-forward earnings ratios. Economist Ed Yardeni, who originally created this concept, terms it the "Blue Angels" chart because the different price-to-earnings (P/E) ratios "fly" in parallel formation like the famed U.S. Navy flight squadron, while the S&P 500 "price-only" Index (the dark blue line) cuts through the "contrails" of the various P/E ratio levels. We like this chart because it not only shows how expensive the stock market is relative to history, but it also provides the current trajectory of forward operating earnings—climbing contrails mean earnings estimates are on the rise, supporting a higher stock price at a given P/E ratio.

**Exhibit 4: Most High**

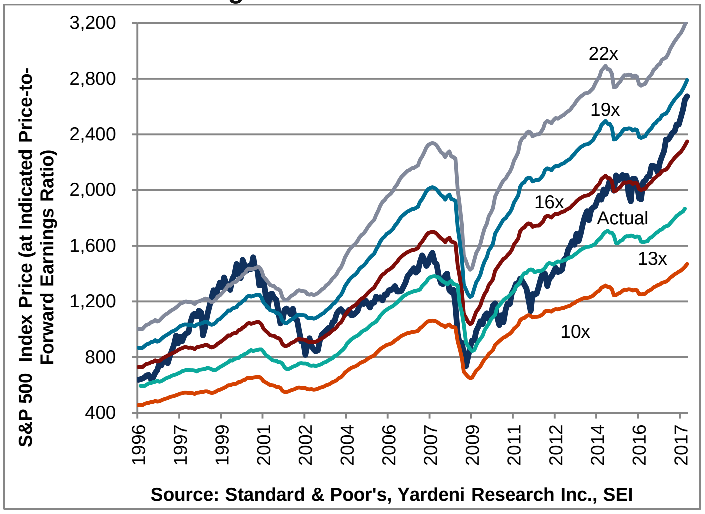
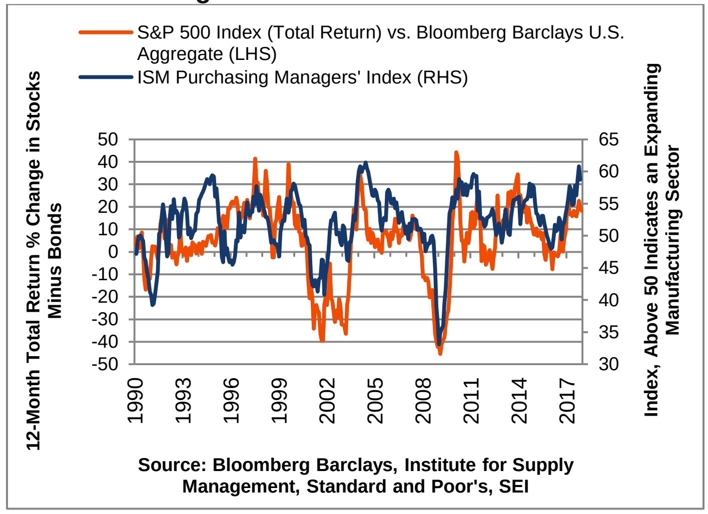



**Exhibit 5: Going Down**



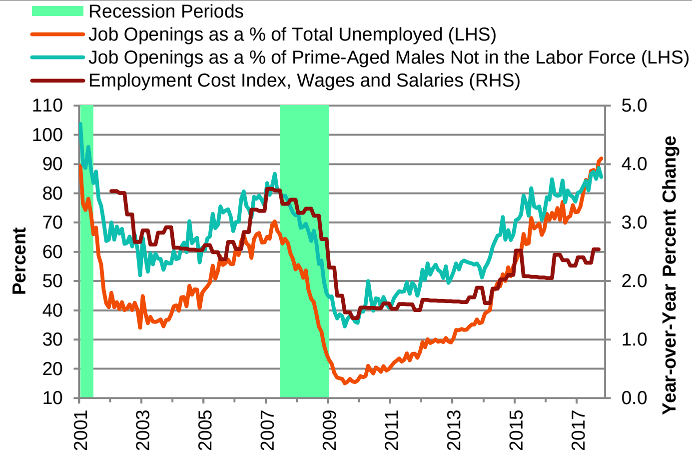

Clearly, stock prices are rising because earnings are advancing smartly AND the earnings multiple is expanding. In the past year, the S&P 500 "price-only" Index logged a 19.4% advance. A little more than three-fifths of that gain came from improving earnings, while the rest was due to the rise in the P/E ratio from 16.8 at the end of last year to 18.0 as of December 31, 2017. There's no denying that valuations are elevated, especially when compared to five years ago. Still, we would argue that even this lofty valuation should not be considered a bubble since it can be justified by the low level of bond yields and the strong trend in profits growth. Of course the higher the valuation, the more vulnerable the stock market becomes to unanticipated bad news. Until the Blue Angels change course and dive back toward earth, we're going to give the bull market the benefit of the doubt.

We certainly would not rule out a garden-variety correction in stock prices of 5% to 10% somewhere along the line. The market is overdue for one—in 2017, the S&P 500 Index didn't even register a price correction of 3%. We're sympathetic to the view that prices now discount much of the good economic news out there. Exhibit 5 compares the Institute for Supply Management's U.S. manufacturing purchasing managers' index (PMI) against the 12-month change in the S&P 500 Index (Total Return) minus that of the Bloomberg Barclays Aggregate Bond Index. Although not perfect, a rising PMI is more often than not associated with relative strength in equities versus bonds; as the PMI falls, the bond market is the better relative performer. If the PMI fades toward the 50 demarcation line (a value below 50 signals a contraction in the manufacturing sector), we could see the market's current exuberance curbed.

We won't be really concerned, though, unless we see a more aggressive swing in Fed policy toward monetary tightness—something we don't anticipate in the coming year. Although the Fed's Board of Governors will witness major personnel changes as Jerome (Jay) Powell replaces Janet Yellen as Chair and as other Trump appointees assume their positions, along with a new president of the New York Fed during 2018, we do not expect major revisions in the central bank's basic approach to monetary policy. The Fed is an institution with a culture that values collaboration and consensus. We do not see the new chair as a bull in a china shop. As was the case last year, we expect the Fed to raise the federal funds rate three times this year, consistent with the Federal Open Market Committee's internal forecast. If the interest-rate normalization process continues, the Fed's policy stance would still be in a moderately expansive position at the end of 2018.

It's possible that the U.S. will see inflation pressures finally begin to build in the New Year. Most labor-related statistics strongly suggest that the U.S. economy is approaching full employment. Exhibit 6 shows that jobs are going begging for lack of qualified candidates. According to the U.S. Department of Labor, there were six million job openings in the non-farm sector as of October 2017. This was equivalent to 92% of the officially unemployed, which totaled 6.5 million persons that month (and the highest percentage since jobs-opening data were first collected in 2001). It also amounted to 85% of all prime-aged males not in the labor force (the highest percentage since nearing the peak of the previous expansion in 2007).

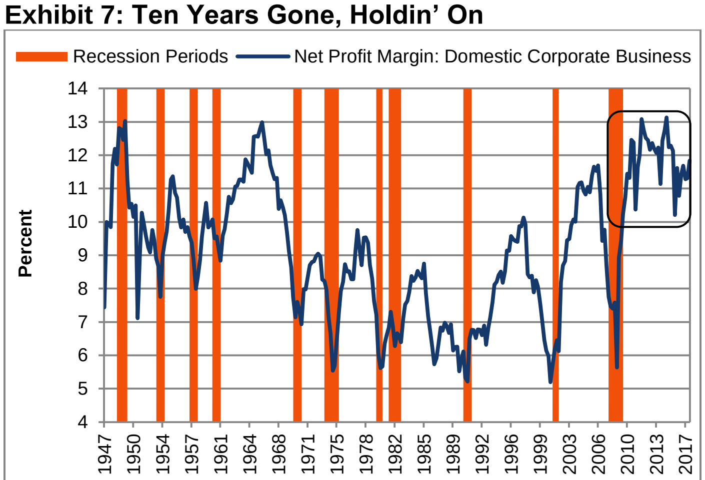
**Exhibit 6: Jobs Go Begging**




Source: Economic Cycle Research Institute, U.S. Department of Labor, SEI

While Exhibit 6 reveals some acceleration in wages and salaries (as measured by the Employment Cost Index), the year-over-year increase remained a low 2.5%. At the peak of the last cycle, wage increases were running a full percentage-point higher than they were as of December 31, 2017. Meanwhile, unit labor costs (the difference between the growth in total employee compensation and the change in productivity) registered an outright decline over the 12 months ended September. This means companies maintained profit margins without resorting to price increases. As Exhibit 7 shows, profit margins have held steady at unusually high levels throughout this long expansion.

**Exhibit 7: Ten Years Gone, Holdin' On**




Source: Bureau of Economic Analysis, ECRI, Philosophical Economics, SEI

We are looking for low, but positive, returns from U.S. equities in 2018. The U.S. large-cap market appears expensive, but there is the expectation that prices will be supported by the fact that earnings yields (that is, the earnings-to-price ratio) remain above bond yields. Our strategies are overweight companies with value characteristics in their portfolios. In similar fashion, small-cap stocks look expensive relative to the past 10 years, but valuation concerns are somewhat mitigated by low interest rates. Low-quality companies have rallied persistently through this year, with loss-makers outperforming profitable companies by a factor of two to one. Most of our strategies have increased their cash levels. The biggest exposure in our small-cap portfolios is toward value.

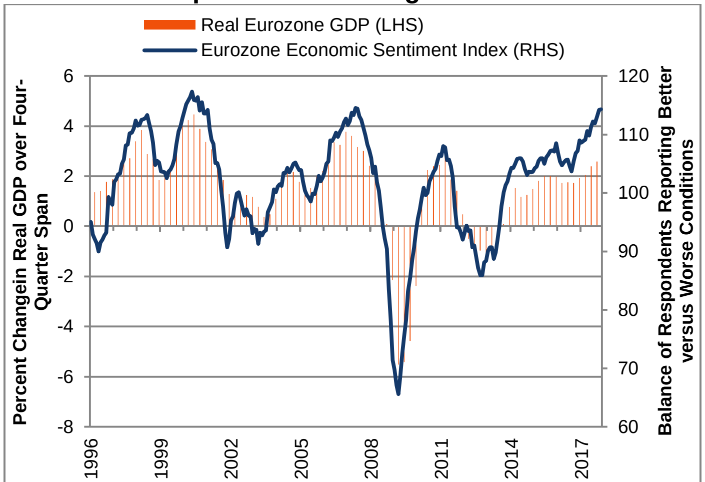
Our fixed-income strategies are positioned for a continuation of slow economic growth as the U.S. economy bumps up against capacity constraints and monetary-policy normalization by the Fed. It projects a year-end 10-year Treasury bond at 2.5% to 3%. Tighter U.S. monetary policy and the ramping-up of quantitative tightening could lead to more-volatile conditions in the second half of the year—especially if the European Central Bank (ECB) moves to reduce its quantitative-easing stimulus more quickly than currently expected. Our strategies are generally reducing risk, although still favor corporate credit; they are overweight financials and underweight industrials. We remain positioned for a further flattening of the yield curve, yet the magnitude of that position changes as the long bond (30-year maturity) fluctuates. The duration of our portfolios is close to the benchmark, with deviations as a result of the yield-curve trade or hedging activity. There is no outright bet on the direction of interest rates.

In the high-yield market, bond prices fell in November and edged still lower in December, resulting in the first negative months since August. This weakness stemmed from concerns about the U.S. government tax package, which caps the deductibility of interest at 30% of earnings before interest, taxes, depreciation and amortization for four years, and 30% of earnings before interest and taxes thereafter. Despite these concerns, not much has changed in our positioning from the previous quarter. The maturity date of the bonds in our portfolios is slightly less (short duration) than those in the benchmark; the average quality of the portfolio is in line with the index (underweight BB rated securities, overweight B rated paper). Coupon-like returns in the 4.5% to 7% range are expected for 2018. We remain comfortable with the outlook, calling for a further decline in default rates.

**Europe Rocks and Rolls**

For most of the past decade, Europe was the land of ice and snow economically. That's not the case anymore. Through the third quarter, the eurozone economy, as measured by inflation-adjusted GDP, advanced by 2.6% on a year-over-year basis. By comparison, the U.S. grew by only 2.3% over this period while the U.K.'s increase amounted to only 1.5%. More-timely data reveal economic acceleration through the fourth quarter. The eurozone purchasing managers' index hit a record high in November. The services sector, meanwhile, reached its highest level since early 2011. The European Commission's eurozone economic sentiment indicator, highlighted in Exhibit 8, is a broad measure of business confidence within the European Union (EU). As seen in the chart below, it has a strong correlation with eurozone GDP growth. It, too, continues to accelerate, and has now reached the previous pre-crisis peak in 2007.

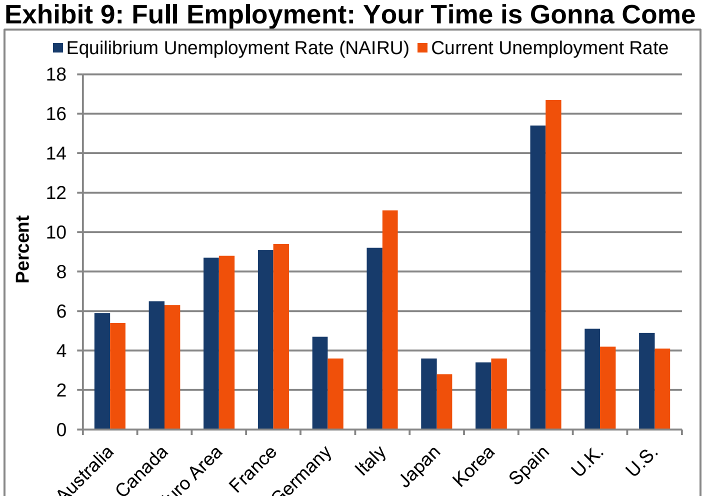
**Exhibit 8: Europe Back in the Light**




**Source: European Commission, Eurostat, SEI**

Despite the evident momentum in the regional economy, the ECB looks for a modest 2.3% gain in 2018 and a further deceleration of growth to 1.9% in 2019. This strikes us as unduly cautious. We suspect that the disappointing economic experience of the past decade has turned European economic forecasters into congenital pessimists. Economists at the OECD, for example, peg the so-called non-accelerating inflation rate of unemployment (NAIRU) in the eurozone at 8.7%, with huge variations among countries. We show the NAIRU of selected countries in Exhibit 9. Over the past 12 months ended October, the eurozone's unemployment rate declined by a full percentage point to 8.8%. Does anyone truly believe that the labor market in Europe has reached the level that will touch off wage inflation?

**Exhibit 9: Full Employment: Your Time is Gonna Come**

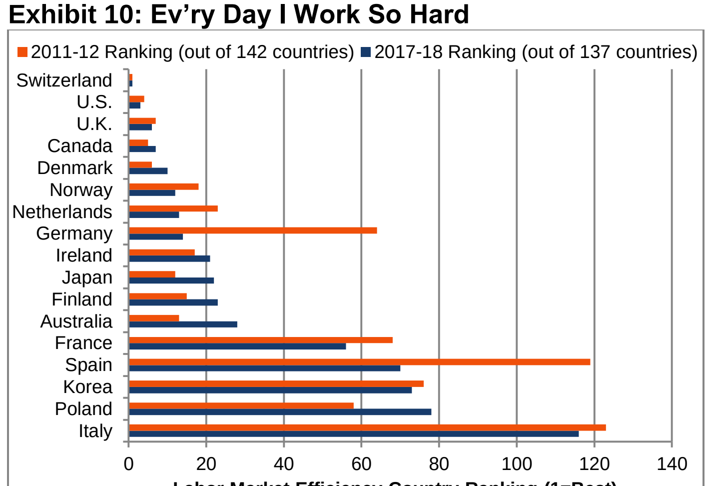



**Source: OECD, SEI**

In our opinion, Europe has far more growth potential than that. The estimates of the output gap (that is, actual versus potential economic activity) do not take into account the huge amount of "shadow" unemployment—particularly discouraged workers who have dropped out of the labor force and those working part-time or on a temporary contract basis because they cannot find permanent, full-time employment. The figures also fail to recognize the labor-market reforms that are improving the flexibility of the European labor market.

According to the World Economic Forum's annual report on global competitiveness, the high-income countries of Western Europe have made important strides in improving labor-market efficiency since the 2011-to-2012 period. The Forum records labor-market efficiency by a variety of measures, including (among others) labor-employer relations; wage flexibility; hiring and firing practices; redundancy costs; the impact of taxation on the incentive to work; pay and productivity; and female participation in the labor force. Exhibit 10 shows that Germany (the largest eurozone economy) has done particularly well in this regard; the country has vastly improved its hiring and firing practices and is making decent progress in the category of wage flexibility. France, Italy, Spain and the Netherlands—the next four largest eurozone economies—have also recorded improvements in their labor-market efficiency rankings over this period.

**Exhibit 10: Ev'ry Day I Work So Hard**



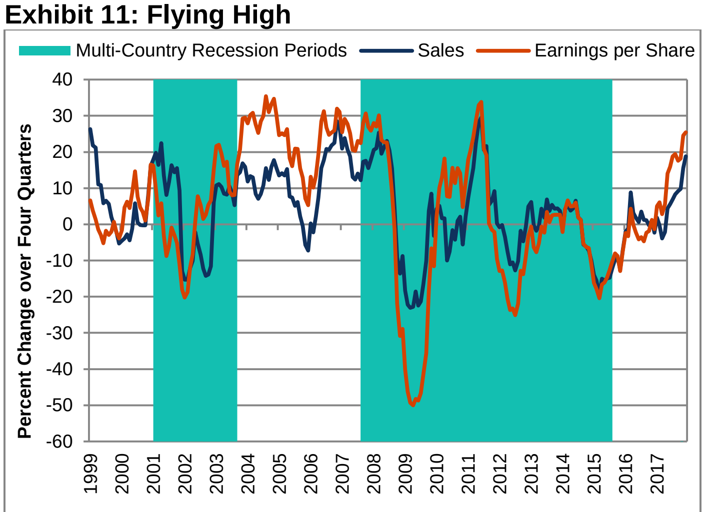

**Source: World Economic Forum, SEI**

We also would note that political concerns in the eurozone are far more muted compared with a year ago. True, all is not rosy for Europe politically. Brexit negotiations overhang any outlook for the future economic health of Europe, although this now appears more problematic for the U.K. than for the Continent. Additionally, the long reign of German Chancellor Angela Merkel has hit a rough patch as she tries to stitch together a workable governing coalition. Nor have we seen the end of the heavy anti-establishment undercurrent that permeates the euro area, especially in those countries that bore the brunt of the periphery debt crisis and the harshest austerity measures. Italy is scheduled to hold parliamentary elections in March; although worries of an "Italexit" from the eurozone have diminished considerably. Even the Catalan separatist movement, which threatened Spain's national integrity, appears to have settled down in the aftermath of the region's parliamentary election. While everybody now realizes that full independence is not going to happen, the election outcome does strengthen the bargaining power of separatists to get more local autonomy from the central government.

In all, we're more optimistic on the eurozone's economic prospects than we have been at any time since the start of the Greek debt crisis in 2010. Given our view that the region is a long way from employment levels that will stir inflation pressures, we expect monetary policy to be supportive of growth throughout the coming year even as the ECB proceeds with its taper of quantitative easing. Unlike the Fed's experience in 2013, markets are not likely to throw a "taper tantrum" in 2018. ECB President Mario Draghi has frequently stated the Governing Council's desire to keep interest rates at current levels well beyond the point when the bank's asset-purchase program comes to an end. Since these asset purchases will continue at least until the end of September, it appears that policy rates will stay put until 2019.

Thus the way is clear for further growth in economic activity during the year ahead. We should see a continuation of the past year's strong revival in corporate revenues and earnings. Exhibit 11 highlights the fact that analysts' forward estimates for revenues have gained 18.8% in the past year, while EPS are projected to be up by 25.5%. These are the best forward views since the early recovery stage following the global financial crisis. Unlike that earlier episode, we do not anticipate the rebound to be cut short by another periphery debt crisis.

**Exhibit 11: Flying High**




**Source: ECRI, MSCI, SEI**

Despite the better-than-expected economic backdrop and strong earnings trend, eurozone equities were relatively disappointing in 2017, with the MSCI EMU (European Economic and Monetary Union) Index (Total Return) gaining 13.4%. While this was a terrific gain in absolute terms, it lagged the U.S. stock market by 8.5 percentage points. Eurozone equity performance was held back by large-cap stocks, which gained just 13.3%; mid- and small-cap companies performed significantly better (registering respective total returns of 20.5% and 25.1%), as they are more domestically oriented and less exposed to the euro's strength,. On the bright side, the forward P/E ratio on the MSCU EMU Index is no higher as of December 31, 2017, than it was at the start of 2017. Solid economic growth and cheap equity valuations are usually a good combination for investors.

**Brexit and the Dis-United Kingdom**

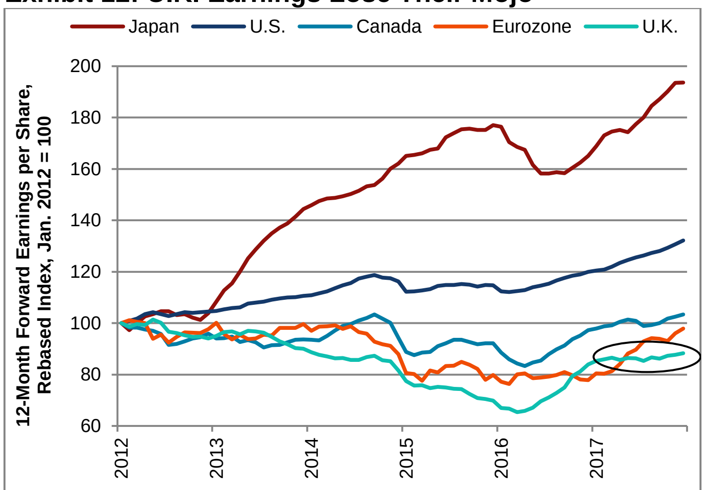
There's a bustle in Westminster's hedgerow—will it lead to a spring clean(ing) for the May government? These have not been easy days for U.K. Prime Minister Theresa May. Ever since the general election last June badly backfired on her, leaving her party with a wafer-thin majority in Parliament, she has been forced to negotiate the terms of exit from the EU from a position of weakness. Agreeing upon the "terms of divorce" has taken up a lot of time, highlighting how unrealistic the breezy assumptions of the Brexiteers were regarding the country's ability to make money on the deal. That stage of the talks has finally concluded, with the U.K. mostly acceding to the EU's demands concerning the financial settlement, citizens' rights and maintaining an open border between the Republic of Ireland and Northern Ireland. The last item is not really resolved, however. There was, instead, a diplomatic fudge that could eventually come back to haunt the May government as it tries to reconcile the need for an open border on the Emerald Isle with the determination of Northern Ireland's Democratic Union Party (the Conservatives' coalition partner keeping May's government afloat) to have no barriers between Northern Ireland and the rest of the U.K. To add insult to injury, Parliament has begun to flex its muscles on the issue of Brexit, reserving the right to vote on the final withdrawal agreement. Parliamentary disapproval would force the parties back to the negotiating table. Keep in mind that any changes to the withdrawal agreement demanded by Parliament would also entail unanimous approval of the 27 members of the EU on the other side of the negotiating table.

It is ironic, but May's political weakness is what keeps her in power at the moment. Bringing down the government could result in a Labor government led by Jeremy Corbyn, an outcome that would almost certainly degrade the economic and investment outlook. Then again, that outlook has already been degraded by the political decisions of the past 18 months.

Despite our concerns for the future, the U.K. economy continues to move along, albeit at a more-sluggish pace than that of Europe or the U.S. The pace of growth has been decelerating since 2014, although there is no indication that a recession is around the corner. Gross fixed capital formation (a component of GDP) has slowed below a 1% growth rate as Brexit uncertainties discourage risk-taking. The housing sector also appears to be waning; mortgage approvals have declined more than 5% over the past year, having trended lower since around the time of the Brexit vote. Most worrisome for homeowners has been the trend in home pricing. Price gains have decelerated significantly, particularly in the London market. Although construction output volumes have been relatively strong, they're also quite volatile. If the industry turns down, it doesn't appear services or manufacturing will be able pick up the slack.

The decline in the trade-weighted value of the sterling (down 17% since August 2015 and 11% since the Brexit referendum) has improved the country's current-account balance. Two years ago, the current account deficit as a percentage of GDP was greater than 6.5%. Now the deficit totals only 4.6%, its best reading in the past six years. Sterling's depreciation has also helped to prop up earnings, although the bulk of the improvement in one-year forward EPS came in 2016. Exhibit 12 suggests that analysts are more cautious on the U.K.'s earnings prospects than on those of other major economies.

**Exhibit 12: U.K. Earnings Lose Their Mojo**




Source: MSCI, SEI

The downside of the pound's weakness has been an uptick in inflation. Both headline and core (which excludes energy and seasonal food) are tracking near 3% on a year-over-year basis, putting pressure on household incomes. Although consumption continues to grow at a moderate pace, the national household saving rate has sunk below 6% (a low level historically). As in the U.S., the unemployment rate is extremely low and near the level that could drive inflation higher. The Bank of England (BOE) raised its policy rate to 0.5% at the beginning of November, basically reversing the cut made in August 2016 in the aftermath of the Brexit vote. The consensus view is for a slow normalization of rates. The BOE's Monetary Policy Committee forecasts only two rate increases between now and the end of 2019, on the assumption that inflation returns to its 2% target level.

While time will tell whether the BOE's economic projections and its view regarding future policy moves are any more accurate than those of the Fed, policymakers in the U.K. face tremendous economic challenges and uncertainties over the next few years. We think investors should tread lightly until there are clearer signs that inflation pressures have peaked and Brexit negotiations actually yield a favorable economic outcome for the country.

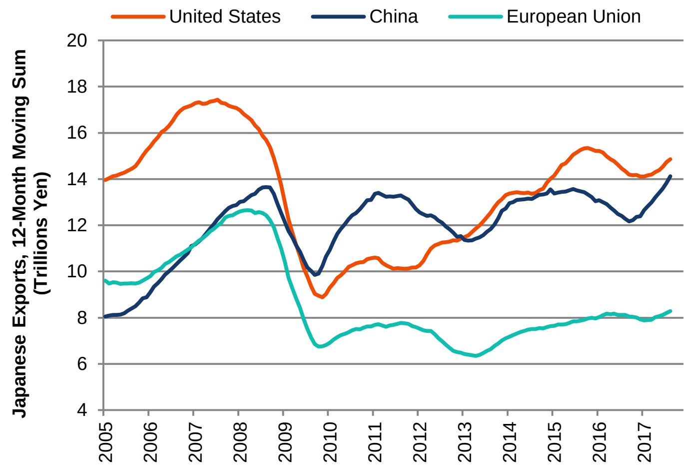
We see Europe as offering good relative value and are looking for equity prices to push higher in 2018. High-quality and stable businesses remain expensive, but the overvaluation is not as extreme as it was a year ago. Our strategies remain underweight. Meanwhile, momentum trades do not appear terribly crowded at this juncture in areas outside of technology, and are therefore attractive. Our U.K. and European strategies also remain tilted toward value, but that bias is moderating as valuation dispersions narrow and managers seek to reduce risk. Overall, we remain pro-cyclical and positioned for expansion.

**Japan Manages a Comeback Now and Zen**

It's been a long time, been a long time, been a long, lonely, lonely, lonely, lonely time for Japan's economy. Only recently did it join the rest of the world in kicking up to a higher gear. The country's year-over-year gain in GDP through the third quarter of 2017 amounted to 2.1% in both nominal and inflation-adjusted terms. Exports were driving this growth, with a year-over-year gain of 6.3%. Capital formation (a 2.8% rise) also was something of a bright spot. Household consumption remained lackluster, however, logging a 0.9% increase.

The country is clearly benefiting from the global economic recovery. Exhibit 13 highlights the fact that exports to China are growing particularly sharply, now accounting for 19% of the total. That's about the same as the share of exports going to the U.S. Exports to the U.S. and Europe also have accelerated, but not to the same extent.

**Exhibit 13: Japanese Exports: I Like the Way You Move**

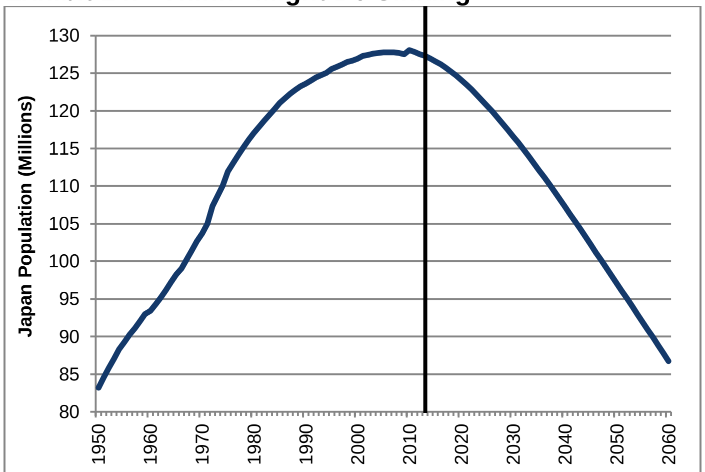



Source: International Monetary Fund, SEI

Japan's labor market has tightened considerably in recent years, although the national unemployment rate has always tracked much lower than those of other developed countries. It reached a high of 5.5% in 2009 at the trough of the global recession and has now declined to a 23-year low of 2.8%. The jobs-to-applicants ratio also has soared. Yet, as in the U.S., wage gains remain muted, keeping the core inflation rate near zero over the past year.

Although there have been rumblings that the Bank of Japan would like to take a step away from the extraordinary monetary policies that have been in place since the financial crisis, the central bank may find it difficult to do so. Domestic demand remains too weak and the population has begun contracting. Indeed, as highlighted in Exhibit 14, the population decline is expected to accelerate in the decades ahead.

**Exhibit 14: I Think I Might Be Sinking**




Source: OECD, SEI

The OECD projects that Japan's population will fall below 87 million by the year 2060. That would be the lowest population reading for the country since 1952 and a 31% decline from today's level. Japan's prosperity will continue to depend in large part on its ability to export and remain competitive. That entails keeping the yen weak through negative interest rates and quantitative easing. The country may eventually be forced to start singing the immigrant song in order to deal with the looming labor shortage. We won't hazard a guess as to when that will happen since opening up the country to immigration would mark a cultural revolution, not merely an economic or political one. But necessity is the mother of invention and the need to add to the prime-age population will grow more and more critical in the decades ahead.

Japanese equities did well in 2017, with the MSCI Japan Index (Total Return) rising by 20.1% on a local-currency basis. Remarkably, the forward P/E ratio declined since the beginning of the year despite the improvement in economic fundamentals. It remains one of the more-cheaply valued stock markets among developed countries. As shown earlier in Exhibit 12, security analysts are becoming more bullish on Japan. Forward-earnings estimates have climbed sharply in the past year; we note that revenue estimates are inflecting higher too.

Corporate governance continued to improve. Publicly traded companies have turned into net buyers of their own equity. This is a major change in behavior. Instead of diluting current shareholders, Japanese companies have added 260 basis points to per-share earnings by reducing the number of shares outstanding. Meanwhile, dividend payments have grown at a 12% per annum rate over the past five years, further underscoring Japanese companies' increasing acceptance of American-style corporate activities that favor equity investors.

We are nonetheless turning a bit cautious following the stock-price run-up. Although the forward P/E ratio remains well below that of U.S. equities and is comparable to the one prevailing in the eurozone, the ratio has advanced almost three multiple points from the middle of 2016.

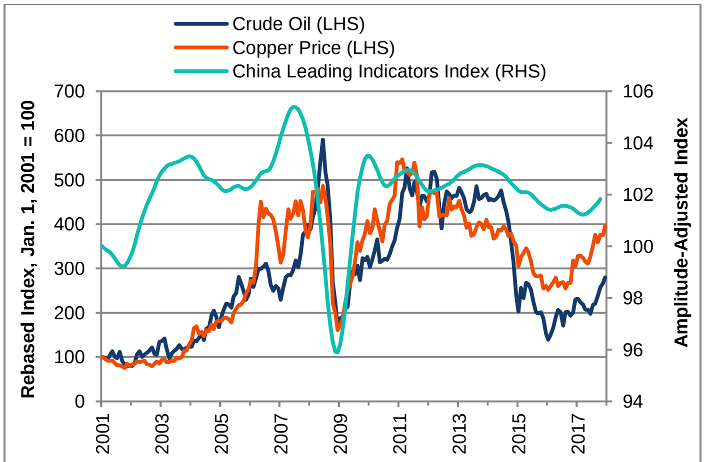
## Emerging Markets: All That Glitters

Emerging markets were the rock stars of the investment world in 2017. This time last year, we were neutral on the group and particularly cautious on China, based on our concern that one of Donald Trump's first actions as U.S. president would be to designate that country as a currency manipulator. This was not a good call for us. The MSCI Emerging Markets Index (Total Return) climbed by 31% last year in local currency. In U.S. dollar (USD) terms, the gain totaled 37.8%. Among the BRICS countries (Brazil, Russia, India, China, South Africa), China was the lead singer, recording a total return of 55% in both local and USD terms. India also scored an above-average performance, with a total return of 30.5% in local currency and 38.8% in USD terms. Russia, by contrast, severely lagged, rising by just 6.1% in USD terms and by less than 1.2% in local currency, despite the upward bounce in oil and metal prices. Beyond the BRICS, other notable performers last year included Poland (gaining 55.3% in USD terms and 29.3% in local currency) and Turkey (with 39.1% in USD terms and 50.4% in local currency).

China, of course, is the big (black) dog in the emerging-market universe. Its economy expanded more-or-less consistently through the year, guided by the heavy hand of the government and the Communist Party. Although the country continues to reduce its dependence on pollution-creating heavy industry and increase the value added to GDP from service-producing industries, there was some backsliding last year as the government pushed for strong economic growth and high employment in the lead-up to October's National Party Congress. While these macro statistics need to be taken with a grain of salt, it appears that China's growth has accelerated significantly from two years ago and is advancing at its fastest clip since the 2012-to-2013 period.

The OECD's amplitude-adjusted Leading Economic Indicators statistic also suggests that the economy will continue to grow at an above-trend pace in the months ahead. This OECD measure tracks the money supply, turnover on the Shanghai Stock Exchange, crude steel and chemical fertilizer production, auto manufacturing, building construction and overseas orders of some 5,000 industrial enterprises. As Exhibit 15 shows, the swings in China's leading indicators correlates to an extent with the ups and down of copper and oil prices. If China can maintain its positive momentum, commodity prices should continue to rally as well.

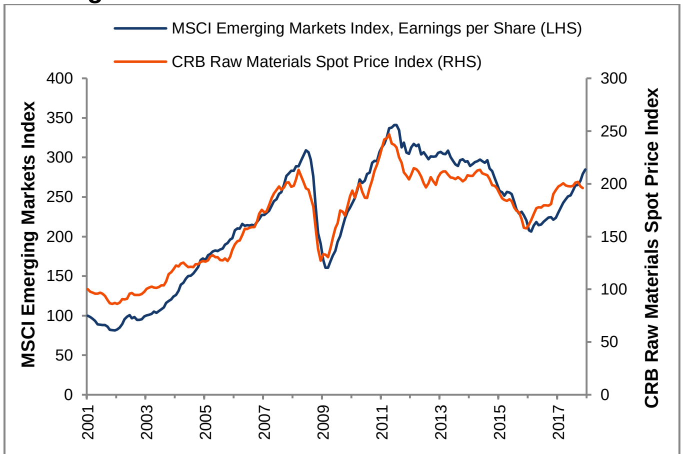
**Exhibit 15: A Whole Lotta Love for China**




Source: Commodity Research Bureau, London Metal Exchange, OECD, SEI

Exhibit 16 underscores the strong correlation of commodity pricing and the EPS of the components of the MSCI Emerging Markets Index, even though one might think that the move into higher-valued activities by the largest and most advanced countries would reduce that connection. Estimated forward earnings jumped 37% in USD terms since the trough in the Commodity Research Bureau's raw materials price index. In other words, more than half of the gain in equity in total-return terms over this timeframe has been backed by profits growth. The rise in the forward MSCI Emerging Markets Index P/E ratio, from 10.5 in February 2016 to 12.5 in December 2017, still leaves it at a deep discount to that of the MSCI World Index forward P/E ratio.

**Exhibit 16: Where Commodities Go, Earnings Will Follow**




Source: Conference Board, MSCI, SEI

Our emerging-market strategies remain positioned for cyclical growth. In China, they increased their commodity-related and industrials exposure. Exposure to Asian technology exposure, however, was trimmed in favor of India.

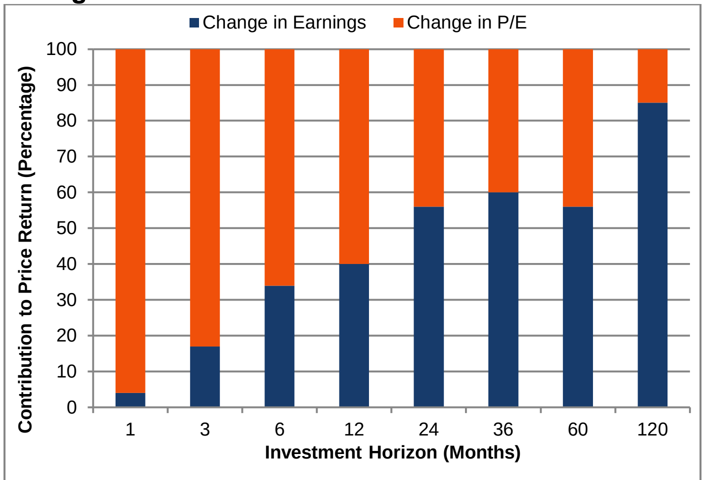
In fixed-income markets, emerging-market debt climbed by 9.4% on a total-return basis, as measured by the Bloomberg Barclays EM USD Sovereign Index. We are overweight local-currency debt and are close to the duration benchmark. Local foreign currency provides the bulk of the risk. We are primarily focusing on opportunities. Argentina and its economic-reform program show promise, as does Egypt, a recipient of funding from the International Monetary Fund. Weakness in Brazilian and South African bonds also provides opportunities. Underweights include the Philippines and Hungary—a result of high valuations.

## Summing It Up: Still Waiting to See Signs of Wearing and Tearing

We have held a positive view of risk assets for most of this long bull market. When speaking to investors who are nervous about the stock market's valuation, we urge them to keep a longer-term focus. Timing the market in anticipation of a short-term correction should be discouraged. As we've seen in the past year, making a major de-risking move could result in a significant opportunity-loss at a time when the stock market's momentum is quite positive and there are few, if any, signs of major economic imbalances or frothy valuations. Until we see a more significant deterioration in the economic and financial fundamentals that have underpinned the global bull market in risk assets over the past two years, our default investment stance is to stay the course.

It's also important to remember that there's a certain serendipitous quality to short-term movements in the stock market. Exhibit 17, provided by investment strategist Myles Zyblock of Dynamic Funds, breaks down the change in the S&P 500 Index price return between the contribution provided by operating earnings and by the change in the P/E ratio versus various investment horizons.

**Exhibit 17: There's Still Time to Change the Road You're On**




Source: Myles Zyblock, Dynamic Funds, SEI

In any given month, precious little of the change in the stock market can be attributed to earnings: on average, less than 5% of the return. Even at the end of one year, changes in valuation dominate. This reflects the importance of investors' expectations in the price-setting process. Over a two-year time horizon, however, fundamentals start to matter more than investor psychology. But it's not until one looks at the market over a 10-year time frame that earnings become the primary driver of equity value. That's why we focus the bulk of our asset allocation on strategic investing, employing long-term capital-market assumptions.

And, so, we will maintain our risk-on bias until we see more evidence that such a stance merits revision. We list below, in terms of decreasing likelihood, the events/developments that would alter our near-term views (what we call "gray swans"):

- An unexpected acceleration in global inflation that forces the Fed and other central banks to step up the pace of interest-rate increases beyond those already projected
- A harsher investor reaction to attempts by the Fed and ECB to normalize their balance sheets (that is, a 2013-style taper tantrum)
- A melt-up in stock prices that pushes the 12-month forward P/E ratio beyond 20 times earnings
- Signs of a sharp deterioration in before-tax profit margins as wages and interest rates rise
- A policy mistake in China that causes a credit crunch in its financial system and the property markets, leading to a sharper slowing of economic growth than intended
- A disruption in U.S. trade relations with China or its NAFTA partners
- A geopolitical event (for example, military action in South Korea, or a spike in oil prices toward $80 to $100 per barrel in the event of war in the Middle East between Saudi Arabia and Iran)
- Evidence revealed by U.S. Special Counsel Robert Mueller that leads to an impeachment attempt of President Trump, especially if Republicans lose their majorities in the House and Senate in November 2018

While these gray swans would have a big impact, they have a low probability of actually happening. We therefore think it is best just to keep calm and ramble on.

## Glossary

**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.

## Index Definitions

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

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

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

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

**Composite Index of Leading Indicators:** The index of leading indicators is a composite of 10 forward-looking economic indicators whose movements tend to lead changes in the overall economy.

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

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

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

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

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

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

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

**Russell 1000 Index:** The Russell 1000 Index includes 1,000 of the largest U.S. equity securities based on market-cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.

**Russell 1000 Growth Index:** The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

**Russell 1000 Value Index:** The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values.

**Russell 2000 Index:** The Russell 2000 Index includes 2,000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.

**S&P 500 Index:** The S&P 500 Index is 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.