Transition Hits White House and Rates

- The U.S. presidential election enabled Republicans to consolidate control in the White House and Congress, helping to propel an advance in U.S. stocks for most of the month.
- Bond markets faltered globally as yields bounced off near-historic lows. Long-term government interest rates increased around the world and short-term U.S. Treasury rates rose on inflation expectations and the likelihood of a rate hike by the U.S. Federal Reserve in mid-December.
- We think the equity bull market could accelerate through 2017, particularly in the U.S., as campaign promises provide some assurance of policies that should help the U.S. economy at the expense of global trade.

Economic Backdrop

A tighter-than-expected U.S. presidential election ended with a rebuke of the establishment, enabling Republicans to consolidate control both in the White House and Congress. U.S. stocks responded positively for the most of the month after finding their footing, and then levelled off toward the end. U.K. stocks were down a bit overall after a choppy start to the month as a High Court ruling determined government plans to withdraw from the European Union would be subject to Parliamentary approval and European leaders hardened their Brexit negotiating stance; European stocks largely finished November where they started. Oil prices (WTI Cushing and Brent) finished the month on a high note after the Organization of the Petroleum Exporting Countries (OPEC) members put country-level specifics to a production-cut agreement first proposed in September.

Bond markets, however, faltered globally as yields bounced off near-historic lows. Long-term government interest rates increased around the world (yields move inversely to prices), and short-term U.S. Treasury rates increased as well, possibly due to a combination of anticipated inflationary infrastructure spending by the incoming administration and the likelihood of a rate hike by the U.S. Federal Reserve (Fed) in mid-December. The Fed and Bank of England announced no changes following their respective early-November meetings on monetary policy, while the European Central Bank and Bank of Japan did not meet during the month.

U.S. services growth continued apace in November, manufacturing growth continued to advance into more comfortable territory, and construction spending during October stood out as the best since January after a lackluster performance for much of 2016. Jobless claims oscillated near the bottom end of their historical range in November, hitting their lowest level since 1973 early in the month but finishing with a relatively soft, albeit still very low, reading. The October unemployment rate fell back to 4.9% and prior month figures were improved on revisions, with average hourly wages growing by 2.8% year over year — the highest level since July 2008. Additionally, personal incomes rose by 0.6% in October, and September's reading was revised upward by 0.4%. Spending rose by 0.3% in October, as retail sales climbed by 0.8% alongside an upward revision to September's report, with auto sales leading in both months. Accordingly, personal consumption drove the latest reading of third-quarter gross domestic product (GDP) to an annualized 3.2%.

U.K. sales volumes appeared set to improve again in November following a sizeable leap in October's retail sales report thanks to a broad-based advance, supporting the highest year-over-year reading since 2002. Manufacturing growth moderated in November, albeit with new orders and output still advancing, while rising input costs held back further improvement. Consumer prices inched upward in October; strength in motor-fuel and furniture and household equipment was offset by softness in clothing and footwear, recreation and culture, and education, which lagged sufficiently enough to lower the annual inflation rate. The unemployment rate fell in the three-month period ending September to the lowest point in over 10 years. However, the number of people working grew by only 49,000 — signaling a possible hiring slowdown. The latest U.K. GDP report was unrevised at 0.5% for the third quarter and 2.3% year over year.

Eurozone manufacturing activity continued to head in the right direction during November, reaching its best level in nearly three years, and a preliminary survey of services activity reported its best performance in almost a year. Consumer prices rose 0.6% during the year through November, according to an early report; while low, it continues a near-uninterrupted increase that began in the spring. Consumer sentiment improved in November, and industrial sentiment was mixed, although services-sector confidence held firm. The unemployment rate fell to 9.8% in October, its lowest level since mid-2009; youth unemployment failed to improve alongside the month-over-month gain, but was 1.5% lower than its year-ago level. Third-quarter GDP was reported at 0.3%, in line with the prior quarter's pace, and 1.6% year over year.

Market Impact

Global fixed-income markets stumbled in November, as reflected by the Bloomberg Barclays Global Aggregate Index, and major market segments were uniformly negative. U.S. high-yield bonds maintained their lead with a small loss, followed closely by U.S. asset-backed securities. U.S. Treasury Inflation-Protected Securities (TIPS) and mortgage-backed securities fared worse, but were still better off than a majority of the overall fixed-income market. U.S. Treasurys, investment-grade corporate fixed income, and global non-government debt performed in-line with each other, producing middling losses, while foreign-currency-denominated (external) emerging-market debt fell somewhat more steeply. Local-currency denominated emerging-market debt had the worst overall performance, followed at a distance by global sovereign securities.

Global equity markets advanced in November, as reflected by the MSCI AC World Index (Net), led again by the financial sector. Cyclicals performed well, with energy and industrials delivering significant gains, and materials and consumer discretionary also positive. Defensive sectors lagged, especially utilities and consumer staples, while telecommunications was down as well. Information technology and healthcare were also negative. Greece had the best country-level performance by a significant margin, followed by Russia, the U.S. and Peru. Canada, Singapore and Ireland also outperformed. Egypt had deep losses, followed at a distance by Turkey, Mexico and Indonesia. Brazil, the Philippines and the Czech Republic also had double-digit losses.

Index Data

- The Dow Jones Industrial Average Index jumped by 5.88%.
- The S&P 500 Index climbed by 3.70%.
- The NASDAQ Composite Index increased by 2.80%.
- The MSCI AC World Index (Net), used to gauge global equity performance, advanced by 0.76%.
- The Bloomberg Barclays Global Aggregate Index, which represents global bond markets, fell by 3.97%.

- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index that is also known as the "fear index", decreased in the month, moving from 17.06 to 13.33.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, rose from $46.86 a barrel at the end of October to $49.44 on the last day in November.
- The U.S. dollar weakened relative to sterling, but strengthened against the euro and yen, ending November at $1.25 versus sterling, $1.06 against the euro and at 114 yen.

Portfolio Review

U.S. equities had a remarkably strong November, led by the fourth-largest monthly gain in small-company stocks of the past decade. Large-cap strategies essentially matched the benchmark as the strength of stock selection in financials and an underweight to consumer staples was offset by positioning in technology. Concerns about the incoming presidential administration's hardline immigration stance weighed on technology companies given their comparably high concentration of foreign workers. Small-cap strategies had a great month in absolute terms, but trailed the benchmark as cyclical companies outperformed defensive higher-quality names. Internationally, equity markets did not fare as well, although both developed- and emerging-market strategies were positive on a benchmark-relative basis. In developed markets, an overweight and selection within energy was the greatest contributor, but was partially offset by an underweight and selection in materials, as cyclicals rallied in earnest. An overweight to smaller companies was also beneficial. Regionally, a slight underweight and selection within Europe and the Middle East helped, but a substantial underweight to Japan detracted. Within emerging markets, Asian positioning was mixed. Selection in China was beneficial, an overweight and selection in India were challenged, and selection in Taiwan was negative. An overweight to Russia and underweight to South Africa were each relative contributors, while a slight overweight to Turkey detracted. Latin American positioning came under pressure: namely an overweight and selection within Brazil, while country-level performance from Mexico to Chile struggled.

Core fixed income was not spared from November's bond market tumult; the strategy performed in line with its benchmark. Non-government sectors generally outperformed U.S. Treasury's, where the yield curve steepened as long-term yields increased in a greater magnitude than short-term yields, and the strategy's yield-curve flattening bias detracted from performance. A slightly shorter duration posture added, however, as yields rose. Within corporates, an overweight to financials enhanced performance as the sector benefitted from the potential for regulatory reform, attractive relative valuations, and expected improvement in net-interest margins as rates increased. An overweight to commercial mortgage-backed securities (CMBS) was additive as the sector continues to benefit from strong fundamentals and financing needs, offset to a small degree by security selection. Non-agency mortgages continued their recent outperformance, so our overweight enhanced returns. An overweight to asset-backed securities (ABS) and underweight to agency mortgages were also additive. Within high yield, an allocation to collateralized loan obligations (CLOS) was the most significant contributor as it outpaced the broader high-yield market, which in turn topped other fixed-income market segments. Positioning in utilities and telecommunications was also beneficial, but was partially offset by holdings in healthcare, transportation and financial services. Within emerging markets, Mozambique was the only benchmark constituent (at 0.12% of the external index) that had a positive return in November. Strategy positioning struggled, with positioning in external debt coming under pressure, although an overweight to underperforming local-currency bonds was partially mitigated by selection. Exposure to Mexico was hit by the election outcome, while an allocation to emerging-market corporates helped dampen inhospitable conditions.

Manager Positioning and Opportunities

The U.S. equity risk-on rally is in full swing and the market is already discounting a lot of good news; from expected tax cuts to infrastructure spending and deregulation which could be worrisome if earnings don't follow through. Within large caps, we still favor value over core and stability, with an overweight to information technology at the expense of consumer staples. We still like sustainable growth and value within small caps, which leads us to an overweight in industrials and underweights in both real estate and financials. Overseas positioning is similar in both developed and emerging markets, with overweights to information technology and underweights to financials and utilities. We also have significant underweights to real estate and consumer staples in developed markets. Regionally, we favor North America at the expense of Asia-Pacific. We also have a substantial underweight to emerging Asia, which pairs an overweight to India with underweights to Korea, Malaysia and Taiwan. We are overweight emerging Latin America, in large part due to positioning in Brazil. We remain underweight Europe, the Middle East and Africa, with an overweight to

Russia via stock-specific opportunities and an underweight to the troubled economy of South Africa.

Core fixed income has been gradually reducing its yield-curve flattening bias over the last several months, but with the recent curve steepening we would consider adding back to that positioning if rates continue to rise. We will likely add selective exposure to a banking sector overweight given the improving outlook, but we are more neutral to industrials and corporates overall. We have selectively reduced exposure to bonds that have exceeded valuation targets as a heavy new issuance calendar could provide opportunities to add risk back at more favorable levels. Securitized overweights to ABS and CMBS will remain as these bonds offer competitive yields, especially on a risk-adjusted basis. We also maintain an allocation to non-agency mortgages with an eye on the impact, if any, from the recent rise in in interest rates. High-yield positioning continues to favor CLOs, with significant underweights to basic industry centered metals and mining, capital goods, telecommunications, energy and financial services. We prefer bank loans as an attractive alternative to BB rated bonds, and continue to look for securities that are upgrade or acquisition candidates, which can lead to outsized bond returns. In emerging markets, we remain deeply underweight external debt, although by less than in the past, in favor of both local-currency and corporate debt. At the country level, Argentina, Indonesia and Brazil are our largest overweights, contrasted with underweights in China, South Korea and Singapore. In currency terms, we are overweight Indonesia, India and Russia at the expense of China, South Korea and Singapore.

Our View

The unanticipated outcome of the U.S. presidential election will have an impact on the economy and financial markets in the months and years ahead. Yet, we firmly believe that it would be a mistake to base even a short-term investment strategy on the results; this would require accurate predictions on the policies proposed by the new president, whether they become laws, and how they would impact the economy and financial markets.

At a high level, however, campaign promises provide some assurance that we can expect more fiscal stimulus, tax relief, deregulation and less free trade, and as a result, more inflation, interest-rate hikes from the Fed and a stronger dollar. These policies should help the U.S. economy at the expense of global trade. This would likely keep the Fed on its toes and could result in a more consistent rate-hike cycle; but too much tightening too fast could cause a shock. Still, higher rates indicate improved sentiment and should not hinder growth.

We actually think the bull market could accelerate through 2017, with more attractively-valued cyclical and growth sectors leading the way. Corporate earnings, especially in energy, should begin to look better on a year-over-year basis when the first quarter of 2016 rolls off.

There are many things over which investors can lose sleep, but our over-arching investment stance remains unchanged. As long as central banks pursue aggressively easy policies in a world mostly characterized by slow economic growth (not recession) and mild inflation pressures, any pullback in the price of riskier assets should be limited.

One reason for maintaining this point of view is our belief that the U.S. economy is on fairly solid ground. It's true that growth in overall business activity continues to disappoint, but household finances are in good shape as a result of expanding employment and incomes as well as the bull market in stocks and home values. There is little reason to expect a serious slowing in consumer spending.

Our main concern for the U.S. is weakness in business investment, which has negative implications for productivity. Slowing labor productivity growth and an acceleration in labor compensation growth is a bad combination. Since companies have been unable to raise prices sufficiently, the downward pressure on profit margins appears chronic. As this pressure intensifies, we expect companies will become more aggressive in their attempts to push through price increases.
This uptick in inflation, combined with the tightening labor market and steady pace of economic growth, seems to have tipped the balance in favor of a hike in the federal funds rate, probably in December. Fed policymakers have conceded that interest-rate normalization will take years to accomplish, leaving little room to cut rates aggressively in the event of a recession. One result is that risk assets should continue to be well supported, and although equity valuations remain elevated, they still appear reasonable relative to those of high-quality bonds.

Treasury bond yields spiked higher following the election, and they could continue to rise. Historically, yields in the range of 4% to 5% have had a negative impact on growth. That number could be lower in our current environment, but in mid-November, yields for 10-and 30-year Treasury bonds were roughly 2.25% and 3%, respectively — a long way from being problematic. Nevertheless, Treasury yields have fully reversed their declines from earlier in the year, and are now roughly back to where they started. While we have seen some dramatic moves in rates this year, these higher rates are an indication of an improved outlook for economic growth.

With regard to the U.K., many observers have been surprised by the resiliency of its economy, although it is way too soon to sound the all-clear. The BOE has cut its base rate to the lowest level in the multi-century history of the central bank, and restarted its quantitative-easing program and previously successful funding-for-lending scheme. On the fiscal policy side, the new Chancellor of the Exchequer has introduced a new budget that delays his predecessor's plans of achieving a budgetary surplus in order to provide some breathing room. In all, U.K. economic policy has shifted toward easing before the negative effects of Brexit can be felt. However, while no one knows what a final Brexit agreement will look like, we suspect it will be nowhere near the position being pushed forward by various U.K. leaders. Given this uncertainty, we think investment is likely to slow in the months ahead.

Eurozone exports and imports are in decline. Household spending is growing faster than other areas of the economy, as is the case in the U.S. and the U.K., but Europe's consumer rebound remains considerably less robust in comparison with these two countries. Although the labor market has certainly improved over the past three years, the country-by-country levels remain wildly disparate. This is especially so for the youth unemployment rate.

Italian Prime Minister Matteo Renzi became the latest casualty of the ballot box, tendering his resignation as promised after a referendum on constitutional reform went against him on December 4. Markets shrugged off the development, although any gains in a new government by the Five-Star Movement, currently the most formidable Italian opposition party, could reverberate beyond Italy's borders given the party's anti-establishment euro-sceptic platform.

Our inclination is to favor equities and higher-yielding debt securities at the expense of developed-economy sovereign bonds that have extremely low or negative yields. Within equities, we prefer value and aggressive-growth characteristics over stability. In bonds, we favor securitized credit, bank loans and other credit-related trades.

Benchmark Descriptions

nor should it be construed as a recommendation to purchase or sell a security, including futures contracts.

There are risks involved with investing, including loss of principal. Current and future portfolio holdings are subject to risks as well. 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. 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. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Diversification may not protect against market risk. There is no assurance the objectives discussed will be met. 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.

Information provided by SEI Investments Management Corporation, a wholly owned subsidiary of SEI Investments Company (SEI). Neither SEI nor its subsidiaries are affiliated with your financial advisor.