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MONTHLY MARKET COMMENTARY | FEBRUARY 2018

Early February Freefall Erodes January's Jump

Monthly Snapshot

- Stocks plummeted globally in early February as signs of rising inflation in the U.S. led to market expectations for stronger Federal Reserve counteractions.
- U.K. Prime Minister Theresa May rejected the European Union's draft Brexit agreement, while facing competing pressures at home to either embrace the remaining member states post-divorce or avoid shared commitments altogether.
- 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.

Economic Backdrop

February began with all the ingredients for investor disappointment. Stocks plummeted globally right out of the gate as influential long-term Treasury rates continued a steep climb, presumably in response to signs of rising inflation and expectations for a strengthening of the Federal Reserve's (Fed) counteractions. Investor concerns lingered longer than the actual selloff, however, which concluded within the first two weeks of the month. Yet February ended with a return to selloff mode, as all stock markets finished the month negative despite partial recoveries of varying sizes across regions; many, however, retained positive year-to-date performance thanks to sharp gains achieved in January.

An early February U.S. budget agreement ended the second government shutdown of 2018—this time lasting just overnight—providing new fiscal stimulus via $300 billion in spending increases over the deal's two-year scope. President Donald Trump expressed intentions to apply tariffs to steel and aluminum imports as the month concluded, rattling equity markets as well as his fellow Republicans and many in his own cabinet—particularly as this followed a January announcement by his administration about tariffs on solar panels and washing machines, and as Canadian lumber tariffs applied late last year have already contributed to supply shortages, rising costs and upward pressure on new-home prices in the U.S.

The Irish border resurfaced as a dividing line between U.K. and European Union (EU) negotiators following the circulation of a draft EU Brexit agreement, while the post-divorce trade relationship remained a key point of disagreement. The draft, which U.K. Prime Minister Theresa May rejected, sought to retain Northern Ireland within the EU customs union and, therefore, erect a trade barrier with the rest of the U.K. It also aimed to prohibit the U.K. from striking third-party trade deals during the post-Brexit transition period. Prime Minister May offered indefinite leave as a concession for rejecting full rights for EU citizens who enter the U.K. after Brexit takes effect next March. She faced competing pressures at home: businesses and soft-Brexit proponents widely supported the Labour party's plan to establish a U.K.-EU customs union, while hard-Brexit proponents sought no commitments to the EU following the divorce.

Key Measures: February 2018

Equity	
Dow Jones Industrial Average	-3.96%
S&P 500 Index	-3.69%
NASDAQ Composite Index	-1.74%
MSCI ACWI Index (Net)	-4.20%
Bond	
Bloomberg Barclays Global Aggregate Index	-0.89%
Volatility	
Chicago Board Options Exchange Volatility Index PRIOR: 13.54	19.85
Oil	
WTI Cushing crude oil prices PRIOR: $64.73	$61.64
Currencies	
Sterling vs. U.S. dollar	$1.38
Euro vs. U.S. dollar	$1.22
U.S. dollar vs. yen	¥106.71

Sources: Bloomberg, FactSet, Lipper

Italians prepared for a trip to the polls at the beginning of March with about 40% of voters undecided; early results showed a rebuke of the center in favor of populist eurosceptic parties. Greece returned to international borrowing markets in early February for the first time since 2014, successfully raising €3 billion.

The Communist Party of China proposed a change to the country's constitution (widely expected to be adopted at the National People's Congress in March) that would remove presidential term limits and provide President Xi Jinping with an open-ended tenure as China's leader. Plans were also announced in February for the establishment of a domestic Chinese market for yuan-denominated oil futures that will be open to foreign investors.

New Fed Chair Jerome Powell, who took office in early February, offered a favorable economic outlook in his semi-annual testimony on monetary policy to Congress at the end of the month. His comments implied that the Fed may need to act more aggressively (that is, hiking rates faster than anticipated) to address the strengthening economy; financial markets responded with increased volatility. The Bank of England (BOE) was the only major central bank to hold a monetary policy meeting during February. Its Monetary Policy Committee voted unanimously to refrain from making changes, yet its Quarterly Inflation Report depicted modest improvement in the economic outlook.

U.S. manufacturing reports variously depicted a firm-to-sharp expansion in February, while growth in the services sector picked up convincingly. The unemployment rate held firm in January at 4.1%; average hourly earnings growth accelerated to a 2.9% year-over-year pace, the highest since the global financial crisis, from an upward revised 2.7%. Weekly jobless claims fell to the lowest level in 49 years during the second half of February. Economic growth for the fourth quarter was revised downward to a 2.5% annualized rate.

U.K. manufacturing conditions remained firmly in growth mode, essentially in line with January's pace of expansion, while activity in the services sector accelerated to healthier levels. Claimant count joblessness declined in January; the unemployment rate for the October-to-December period edged upward to 4.4%, while average earnings growth for the 12-month period ending December was unchanged from the prior month's year-over-year rate of 2.5%. The latest reading of overall economic growth for the fourth quarter was revised downward to 0.4% (and 1.4% year over year).

Manufacturing and services growth in the eurozone continued to expand at an impressive pace despite slowing somewhat in February; moderation was sharper in the services sector. The unemployment rate was 8.6% in January, matching December's downward-revised report, although youth unemployment improved from 17.9% to 17.7%. The second reading of fourth-quarter economic growth remained 0.6% (and 2.7% year over year).

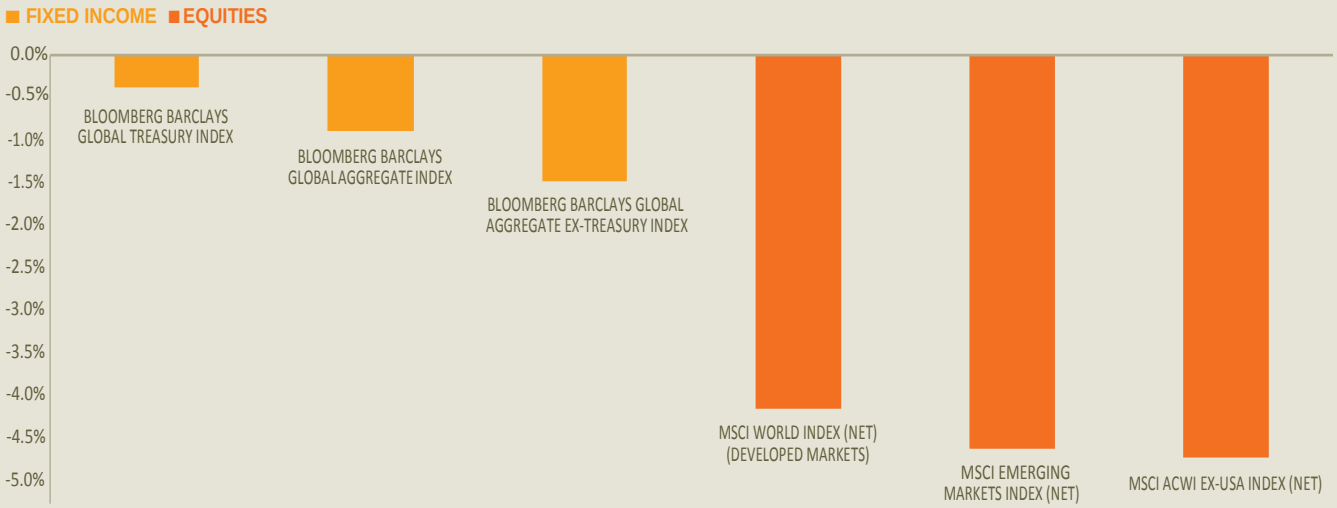
Portfolio Review

U.S. equities declined significantly in February, and growth stocks fell by less than their value counterparts, challenging our large-cap strategy's value orientation. Stock selection in the healthcare and consumer discretionary sectors also weighed on performance. Our small-cap strategy performed well in the context of the broad-based selloff that defined the month, primarily due to a substantial underweight in real estate and strong selection in financials. Overseas, our developed-market strategy struggled amid a decline that engulfed stock markets around the globe. Overweights to the U.K. and an underweight to Japan detracted, as did selection within industrials and materials, while positioning within defensive sectors and momentum exposure helped partially offset the underperformance. Our emerging-market strategy tempered the broader losses delivered by the worst-performing equity subset in February, primarily due to positioning within Asia and technology, as well as selection in commodity and consumer stocks.

The U.S. investment-grade fixed-income market also slid in February; our core fixed-income strategy modestly underperformed the broader market as non-government sectors underperformed comparable U.S. Treasurys. A yield-curve-flattening bias weighed on performance as long-term yields increased by more than short-term yields. Our overweight to the corporate financial sector detracted. An allocation to non-agency mortgage-backed securities (MBS) was additive, while positioning within agency MBS was a drag on performance. An overweight to asset-backed securities was challenged by underperformance of the asset class. Our unfavorable overweight to commercial MBS (CMBS) was softened by a higher-quality bias. An underweight to the non-corporate sector was modestly positive, but an underweight to taxable municipals held back returns. Our high-yield strategy performed in line with its benchmark on beneficial allocations to collateralized-debt obligations and cash, which cushioned against the downturn, as did

Our emerging-market strategy tempered the broader losses delivered by the worst-performing equity subset in February, primarily due to positioning within Asia and technology, as well as selection in commodity and consumer stocks.

Major Index Performance in February 2018 (Percent Return)



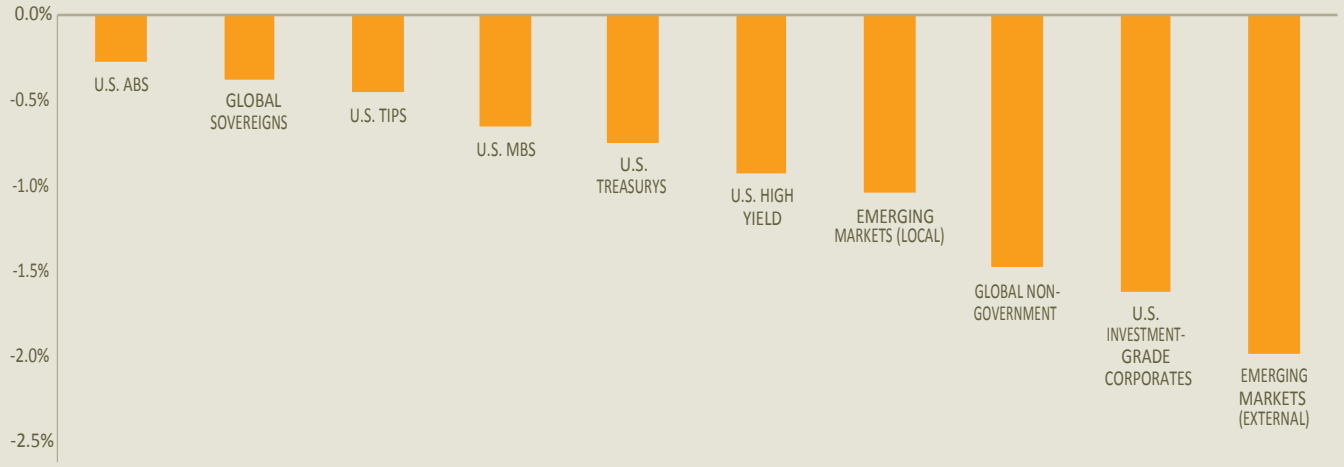
Sources: FactSet, Lipper

an underweight to and selection within banking. Selection within media and real estate detracted, as did overall positioning within financial services. Our emerging-market debt strategy performed well in a declining market, primarily by favoring exposure to local currencies over hard currencies.

Manager Positioning and Opportunities

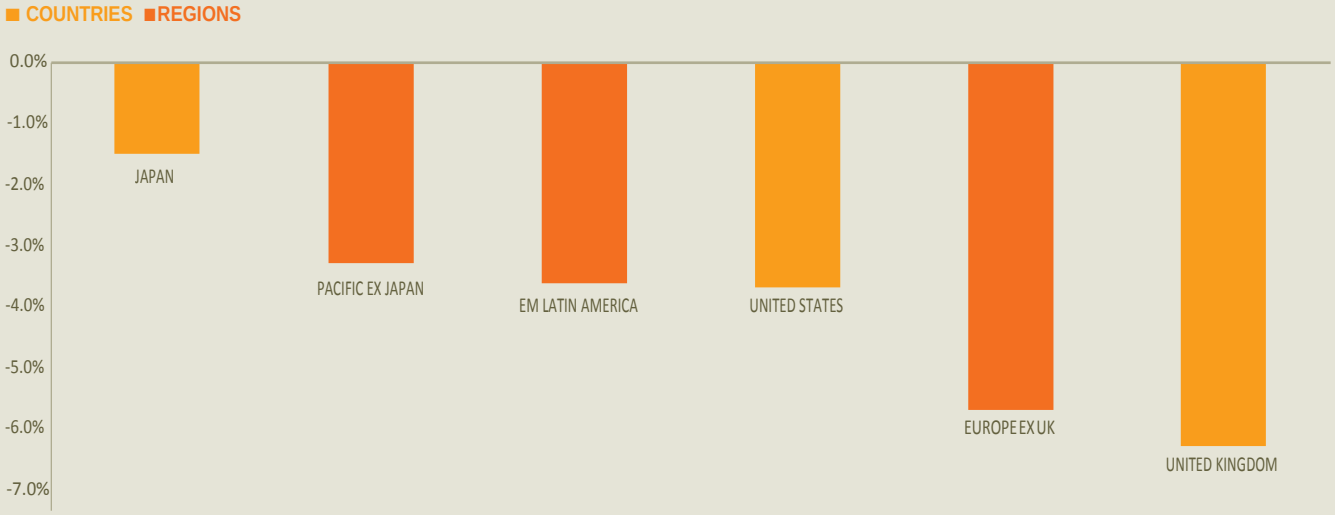
Strong underlying economic fundamentals and positive earnings indicated that U.S. equities may continue to climb. However, elevated volatility could remain due to high valuations, rising interest rates and potential geopolitical events. Our large-cap strategy remained tilted toward value, albeit underweight the high-dividend yield interest-rate sensitive sectors such as utilities, telecommunications services, and real estate investment trusts. Within small caps, we remained cautious and continued to favor stability- and momentum-oriented strategies. Our international developed-market strategy remained overweight growth and momentum stocks while slightly underweight value and defensives. At the country level, we retained underweights to Japan and Australia, primarily via an underweight to financials (our largest sector underweight). Technology was the most significant sector overweight, driven partially by opportunities in Asia that displayed strong fundamentals and sentiment. Our emerging-market strategy retained an underweight to Asia, mostly via the larger, more developed economies of Taiwan, Malaysia and Korea. Our overweight to Indian equities was slightly reduced; we continue to see promise in the country's growth opportunities, like banks, given low credit penetration and weak competition from state-owned banks. We were underweight South Africa despite recent improvement in the country's political landscape. Latin America remained our only regional overweight, thanks to the gradually recovering economies in Brazil and Argentina, as well as holdings in Panama and Peru.

Fixed-Income Performance in February 2018 (Percent Return)



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

Regional Equity Performance in February 2018 (Percent Return)



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

Our core fixed-income strategy added duration as yields increased amid the selloff, ending February slightly above neutral; we maintained a curve-flattening bias. Our corporate exposure remained oriented toward banking and away from industrials and utilities. Overweights to asset-backed securities and CMBS—with a higher-quality emphasis—remained given their competitive risk-adjusted yields; although we initiated selective risk reduction within student loans. An allocation to non-agency MBS was maintained, and agency MBS exposure was reduced from slightly overweight at the end of 2017 to roughly neutral. Our high-yield strategy continued to favor collateralized-debt obligations and cash at the expense of underweights to basic industry, energy and capital goods, to name a few. Other overweights within high yield included leisure, technology and electronics, and media. Within emerging markets, our strategy maintained its overweight to local currencies. Top country overweights included the Czech Republic, Argentina, Egypt and Ukraine, while top underweights were the Philippines, Hungary and Peru.

Our View

The global financial crisis finally appears to be in the rear-view mirror. In its place is synchronized expansion across most developed and emerging economies. Admittedly, developed economies continued to run at a rather sluggish pace of approximately 2% to 2.5% gross domestic product (GDP) growth (as of the latest available figures for the fourth quarter). 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.

Over the next year or so, we think global growth can still be vibrant enough to allow risk assets to perform well.

U.S. tax legislation is hardly perfect: we do not expect it to 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, repatriation holiday, and the full expensing of capital equipment purchases over the next five years are positive developments for economic growth and investment.

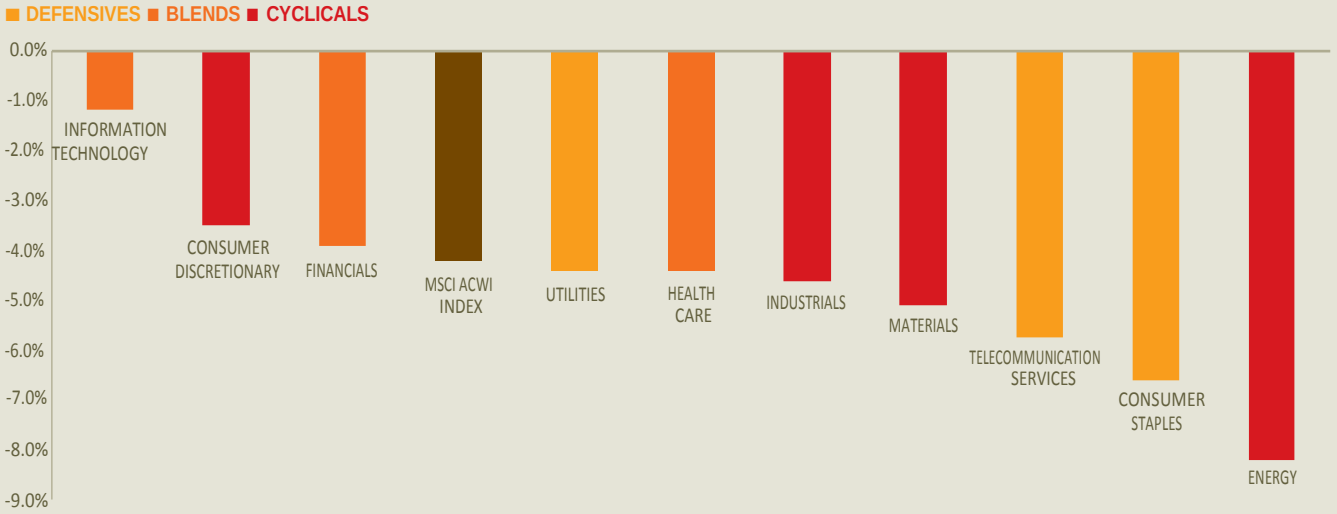
Security analysts, always an optimistic lot, are calling for an 11% rise in S&P 500 Index per-share operating earnings in 2018. Although earnings estimates tend to fade through the year as estimates adjust to reality, this time may be an exception because tax cuts have not yet been taken fully into account.

The major worry for investors comes down to the stock market's valuation. A little more than three-fifths of the S&P 500 Index's price gain in 2017 came from improving earnings, while the rest was due to a rise in the price-to-earnings (P/E) ratio. But elevated valuations 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 unexpected bad news.

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. It's possible that the U.S. will see inflation pressures finally begin to build as 2018 progresses, but U.S. companies have proven able to maintain profit margins without resorting to price increases.

In our opinion, Europe has more growth potential than the U.S. 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 over the last five years. We also would note that political concerns in the eurozone are far more muted compared

Global Equity Sector Performance in February 2018 (Percent Return)



Sources: FactSet, Lipper. MSCI ACWI Index Components (as defined by SEI).

with a year ago, although we have not yet seen the end of the heavy anti-establishment undercurrent.

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 European Central Bank proceeds with tapering its quantitative-easing program. Since these asset purchases will continue at least until the end of September, it appears that policy rates will stay put until 2019.

We therefore believe the path is clear for further economic growth in the year ahead. The strong 2017 revival in corporate revenues and earnings should continue; the MSCI European Economic and Monetary Union Index (Total Return) forward P/E ratio was no higher as of December 31, 2017, than it was a year earlier. Solid economic growth and cheap equity valuations are usually a good combination for investors.

These have not been easy days for U.K. Prime Minister Theresa May. The divorce stage of Brexit talks appeared to have concluded late last year, with the U.K. mostly acceding to the EU's demands; but even this stage appears vulnerable to renegotiation (as evidenced by the latest disagreement over the draft EU Brexit proposal). Parliament has also begun to flex its muscles—and disapproval there would force the parties back to the negotiating table. Keep in mind that any changes to the withdrawal agreement demanded by Parliament would require unanimous approval of the 27 EU members on the other side of the negotiating table.

The BOE's Monetary Policy Committee forecasted only two rate increases between now and the end of 2019. While time will tell whether the central bank's view regarding future policy moves are accurate, policymakers in the U.K. face tremendous challenges 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.

Japan is clearly benefiting from the global economic recovery. Exports to China are growing particularly quickly, and are now about equal to the share going to the U.S. Exports to the U.S. and Europe also have accelerated, but not to the same extent.

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 weak and the population has begun contracting, a trend that will likely accelerate.

Japanese equities did well last year, with the TOPIX rising by 26.55%. Remarkably, the forward P/E ratio declined over the course of 2017 despite the improvement in economic fundamentals. It remains one of the more cheaply-valued stock markets among developed countries. Forward-earnings estimates have climbed sharply in the past year; we note that revenue estimates are also inflecting higher.

It's possible that the U.S. will see inflation pressures finally begin to build as 2018 progresses, but U.S. companies have proven able to maintain profit margins without resorting to price increases.

There are many possible events and developments that could have a big negative impact, but we believe most have a low probability of actually happening. We will therefore maintain our "risk-on" bias until we see evidence that such a stance merits revision.

Emerging-market equities climbed significantly last year, with a particularly strong contribution from China. Despite some backsliding last year, China has continued to reduce its dependence on heavy industry and increase the value added to GDP from service-producing industries. 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. If China can maintain positive momentum, commodity prices should continue to rally as well.

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 when 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.

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Glossary of Financial Terms

Duration: 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.

Price-to-earnings ratio: The price-to-earnings ratio is equal to market capitalization divided by after-tax earnings. The higher the ratio, the more the market is willing to pay for each dollar of annual earnings.

Index Descriptions

All indexes are quoted in gross performance unless otherwise indicated.

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

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

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

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

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

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

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

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

The BofA Merrill Lynch U.S. High Yield Constrained Index contains all securities in The BofA Merrill Lynch U.S. High Yield Index but caps exposure to individual issuers at 2%.

The BofA Merrill Lynch U.S. High Yield Index tracks the performance of below-investment-grade, U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

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

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

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

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

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

The MSCI ACWI Index is a market-capitalization-weighted index composed of over 2,000 companies, representing the market structure of 48 developed- and emerging-market countries in North and South America, Europe, Africa and the Pacific Rim. The Index is calculated with net dividends reinvested in U.S. dollars.

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

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

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

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

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

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

The MSCI Japan Index is designed to measure the performance of the large- and mid-capitalization stocks in Japan.

The MSCI World Index is a free float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed markets. The Index consists of the following 23 developed-market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the U.K. and the U.S.

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

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

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

Corresponding Indexes for Fixed-Income Performance Exhibit

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

Corresponding Indexes for Regional Equity Performance Exhibit

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

Disclosures

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