

# Monthly Market Commentary

## Markets Face Political Pressure

October 2016

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- Financial markets were relatively resilient in October despite some high-profile negative turns in the ongoing sagas of major developed economies.
- The U.S. dollar strengthened relative to other major currencies, weighing on dollar-denominated performance.
- Global fixed-income fared poorly in U.S. dollar terms, led again by U.S. high-yield bonds. Global equity markets also slid, although pockets of strength were visible in Latin America and peripheral Europe.

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### Economic Backdrop

Financial markets were relatively resilient in October despite some high-profile negative turns in the ongoing sagas of major developed economies. The tone of the U.S. presidential election deteriorated alongside a series of “October surprises” that painted both candidates in a terrible light. U.S. equities declined and volatility increased to finish October at its highs for the month. The U.S. Treasury yield curve steepened (yields move inversely to prices) as rates rose across all maturities, with long-term rates increasing in greater magnitude than short-term rates. Crude-oil prices crested mid-month at their highest levels since summer 2015, before sliding to end October more than 9% below their highs.

The U.K.’s negotiating position and timetable came into greater focus as Prime Minister May set a March 2017 deadline to start her nation’s formal withdrawal from the European Union (EU), which could be subject to parliamentary approval depending on the outcome of a court ruling. She also reasserted the centrality of a sovereign immigration policy to the negotiations, which presents a seemingly insurmountable roadblock to continued participation in the common market, thereby increasing the likelihood of a Hard Brexit. Both sterling and the euro weakened against the U.S. dollar, with sterling falling to the lowest level since 1985 (excluding the lows hit during a flash crash early in the month that nevertheless set markets on edge).

The Bank of England (BOE) and U.S. Federal Reserve (Fed) did not have meetings on monetary policy in October, although the former was forced to fend off rumors that Governor Mark Carney was considering his resignation with a statement that he remained committed at least until Brexit negotiations conclude in 2019. The Fed’s early November meeting is not expected to produce any changes, but another mid-December rate hike remains a real possibility based on the latest Fed projections. The European Central Bank (ECB) and Bank of Japan (BOJ) both announced no changes to benchmark rates or asset purchases. The latter’s yield-curve targeting policy produced a short-term rate of -0.1%; whether this helps achieve the BOJ’s stated goal of igniting inflation remains to be seen.

An early reading of U.S. manufacturing activity in October showed promising growth as orders and output hit one-year highs, while consumer confidence settled as the concerns about future job prospects outweighed the current positive sentiment on rising incomes. New jobless claims hit their lowest levels in more than 40 years during October and remained near those levels for the month, following an uptick in the September unemployment rate to 5.0% after adding fewer jobs than expected. The overall economy expanded by a better-than-expected 2.9% annual rate in the third quarter, the fastest pace in two years.

U.K. construction activity edged upward in October, surprising expectations for slower growth and continuing to put distance between this summer’s post-Brexit vote contraction. Manufacturing growth moderated, but remained safely above the slowdown territory of a few months ago. The unemployment claimant count rate ticked upward to 2.3% in September, while the June-August average unemployment rate and year-over-year earnings were unchanged. Third quarter economic growth was a better-than-anticipated 0.5%, but has moderated since the Brexit vote.

Eurozone manufacturing growth accelerated in October, thanks to increasing new and backlog orders, and a preliminary survey of services growth also improved. Economic sentiment retained the prior month’s energy in October, improving at both the industrial and consumer levels. Consumer prices increased by 0.5% for the year through October, according to a provisional reading; while admittedly low for a full-year measure, this marks the sixth consecutive advance. Overall economic growth continued apace, at 0.3% for the third quarter and 1.6% year over year.

## Market Impact

Global fixed-income markets fared poorly during October, as reflected by the Barclays Global Aggregate Index, and most major market segments were negative. U.S. high-yield bonds continued to lead, and were the only positive performing part of the fixed-income market during October. U.S. asset-backed securities (ABS) were essentially flat, U.S. Treasury Inflation-Protected Securities (TIPS) were marginally negative, and losses in U.S. mortgage-backed securities (MBS) were modest. U.S. dollar-hedged (which seeks to reduce U.S. dollar-related volatility) global non-government debt, U.S. investment-grade corporate fixed income, and local-currency denominated emerging-market debt had middling losses, while U.S. Treasuries, dollar-hedged global sovereign securities, and foreign-currency-denominated (external) emerging-market debt declined somewhat more steeply. Unhedged global non-government debt performed poorly, and unhedged global sovereign securities suffered the worst overall drop.

Global equity markets declined in October, as reflected by the MSCI AC World Index (Net), with negative performance across every global sector besides financials. Materials experienced the most modest slide, while information technology, utilities and energy also had comparatively small losses. Healthcare had the sharpest decline, followed at a distance by telecommunications and consumer staples. Latin America and peripheral Europe had a strong month, with Brazil leading at the country level, followed by Egypt, Chile, Hungary and Mexico. The Czech Republic, Austria and Greece also performed well, as did Poland and Spain. The deepest losses came from Belgium, Israel and Finland, followed by Denmark, New Zealand and Switzerland.

## Index Data

- The Dow Jones Industrial Average Index declined by 0.79%.
- The S&P 500 Index fell by 1.82%.
- The NASDAQ Composite Index retreated by 2.27%.
- The MSCI AC World Index (Net), used to gauge global equity performance, declined by 1.70%.
- The Barclays Global Aggregate Index, which represents global bond markets, fell by 2.78%.
- 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”, increased in the month, moving from 13.29 to 17.06.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, fell from \$48.24 a barrel at the end of September to \$46.86 on the last day in October, setting an intra-month high of \$51.60 on 19 October.
- The U.S. dollar strengthened relative to sterling, the euro and yen, and ended October at \$1.22 versus sterling, \$1.10 against the euro and at 105.1 yen.

## Portfolio Review

U.S. equities struggled in October, with small companies lagging large companies by a bit. Large-cap strategies outperformed the benchmark, while small-cap strategies were more evenly matched. For large caps, financials performed well in light of stronger earnings and rising interest rates, which helped create a value tailwind and supported our value managers. On the flipside, small caps were underexposed to financials, which detracted, although a slight preference for quality sustainable companies helped mitigate the downside given the relative outperformance of low volatility stocks. Overseas, developed-market equities declined, as the probability of a rate hike by the Fed increased, which challenged defensive and yield-producing stocks. International-strategy performance was dictated by style, with managers that avoided defensives contributing, while managers with a more defensive orientation underperforming heavily. Regionally, Brexit turmoil has weakened confidence in U.K. equity markets and as a result the U.K. was one of the worst performing regions, so the portfolio's underweight to the U.K. contributed to relative performance. Emerging-market equities slid modestly, outperforming developed markets for the fifth month in a row, and our strategy performed in-line with the benchmark. Asia underperformed broader emerging markets, so an underweight to the region contributed. Poor stock selection in Korea and Taiwan detracted, while holdings in India and Indonesia were beneficial. Our positions in Russia, all chosen for stock-specific reasons rather than macro calls, performed well, and an underweight to South Africa also helped. Latin America was once again the bright spot, benefiting our overweight to the region, but our holdings in Brazil detracted a bit.

Core fixed income performed in line with the market as non-government sectors outperformed government bonds. U.S. Treasuries yields rose for the month in a bearish steepening manner, with long-term yields increasing in a greater magnitude than short-term yields. A yield-curve flattening bias detracted from performance, while a slightly shorter duration posture added as yields rose. An underweight to corporate bonds detracted, although an overweight to financials enhanced performance as the sector benefitted from an improved outlook and relative valuations that have not narrowed as much as other sectors, which improves their attractiveness as this stage of the cycle. Overweights to securitized

sectors — commercial mortgage-backed securities (CMBS), non-agency MBS and ABS — were additive, while an underweight to agency MBS detracted. High-yield strategy performance benefitted primarily from an allocation to bank loans, as well as a security selection within the basic industry and healthcare sectors. Positioning within retail, energy and capital goods were modest detractors. Emerging-market debt performance was down, but our strategy outperformed on country allocations, particularly Mexico and Brazil. Their currencies strengthened relative to the U.S. dollar, so an emphasis on their local-currency denominated debt contributed.

## **Manager Positioning and Opportunities**

There is a lot of good news already baked into U.S. stock prices and earnings expectations for next year are high, which provides reason to proceed with caution at this stage in the market cycle. We continue to prefer mean-reversion value and forward-looking growth strategies over core and stability within large caps. An overweight to technology remains as businesses seek ways to improve efficiency in a lower-growth environment, and we are underweight consumer staples on growth and valuation concerns. Within small caps, we favor stability growth and deeper value as these names have begun to rebound from their lows. We remain underweight financials given the low-interest rate environment, which is not good for net interest margins. We are also overweight industrials given their reasonable valuations and stability/sustainable-growth attributes, and underweight real estate due to the lack of growth and unimpressive valuations. International developed-market positioning is similar: we remain underweight consumer staples, and financials are still the largest underweight. Overweights to information technology and energy continue. Within emerging markets, we still retain exposure to consumers given the positive long-term growth outlook on the strength of the middle class, although we have slightly reduced our consumer discretionary exposure. We increased our energy and materials exposure, and remain underweight financials and overweight information technology.

Core fixed income duration posture remains slightly short to neutral with a diminished yield curve flattening bias; as interest rates remain within a relatively narrow trading range and uncertainty on the future of monetary policy, we will likely make modest adjustments to interest-rate positioning. We have been selectively reducing exposure as a heavy new issuance calendar has the potential to provide opportunities to add back risk at more favorable levels. We remain underweight corporates overall, with an underweight to industrials and overweight to financials, and we will likely add exposure to banks selectively given an improving outlook. Overweights to ABS and CMBS will remain as they offer competitive yields, especially on a risk-adjusted basis. With strong housing market fundamentals, we will maintain an allocation to non-agency mortgages. Within high yield, an allocation to CLOs remains the largest active position, underweights to basic industry, telecommunications, capital goods and financials remain, and we have retained an overweight to technology and electronics. In emerging markets, we have retained a steep underweight to external debt, due in part to an allocation to corporates, and a large overweight to local debt. Local currency has continued to price more cheaply than fundamentals would suggest, and we have added to positions accordingly with the expectation that prices will recover as event risks pass. Our largest country overweights are to Indonesia and Brazil, with an emphasis on local debt, as well as Argentina and Brazil. The largest country underweights belong to China (with a local emphasis) and Lebanon. Significant overweights to the Russian ruble and Indian rupee contrast with an underweight to the Singapore dollar.

## **Our View**

There are many things over which investors can lose sleep: Brexit-related stresses, disenchantment with free trade, ineffective monetary policy, pressure on corporate profit margins, severe debt burdens, and intense political uncertainty. 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.

In general (and especially as it pertains to the U.S.), we continue to view equity-market corrections as buy-on-the-dip opportunities. 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, bonds and home values. There is little reason to expect a serious slowing in consumer spending.

We also expect the change in business inventories — the most volatile part of GDP, which has slowed in recent quarters — to rebound in the quarters ahead, supporting a reacceleration in overall U.S. GDP into the 2.5%-to-3.0% range.

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 slow-but-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 conceded recently that interest-rate normalization will take years to accomplish, leaving little room to cut rates aggressively in the event of a recession. Investors remain skeptical that the central bank will even achieve its stated objective of pushing its policy rate to the upside. As a result, risk assets should continue to be well supported. Although equity valuations remain elevated, they still appear reasonable relative to those of high-quality bonds.

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 picking a winner in November; 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.

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 pre-emptively 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 scrapped his predecessor's austerity plans and is expected to introduce a new budget that abandons any notion of achieving a budgetary surplus by the end of the current parliament. In all, U.K. economic policy has shifted dramatically toward easing well 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.

We're concerned that it's just a matter of time before another crisis tests the cohesion of the eurozone. It's possible that the Italian constitutional referendum, to be held 4 December, could provoke such a crisis. If the vote goes against the government, Prime Minister Matteo Renzi may be forced to make good on his promise to hold elections. Unfortunately for him, polls show that the Italian electorate is in a cantankerous mood.

If the Five-Star Movement, currently the most formidable Italian opposition party, were to win power, the impact would be far more earth-shaking than the Syriza party's January 2015 victory in Greece. Italy's economy is some seven times greater than that of Greece, so one can only imagine how markets will react to the possibility of an Italian threat to leave the euro framework. ECB President Draghi knows he has a potential problem on his hands. He continues to reassure investors that the central bank has the will, the tools and the ability to improve the eurozone's fortunes.

The Japanese economy still lacks momentum despite fiscal stimulus packages, structural reforms and extremely aggressive monetary policy initiatives. Industrial output has trended lower over the past three years, hurt by the slowdown in global trade, and although the country's merchandise trade balance has turned positive, this is merely the result of imports falling faster than exports.

On the positive side, housing construction is running near a cyclical high. The unemployment rate, which is structurally much lower than in other developed countries, has continued to settle. Nominal wages remain stuck near zero, however, and inflation expectations have been nearly impossible to nudge to the upside. Our Asia-focused portfolio managers are heartened by improvements in corporate governance and the use of capital. Additionally, the latest fiscal-policy initiative is a significant one, with new spending amounting to ¥7.5 trillion. In the current fiscal year, stimulus is expected to reach 4.5% of GDP.

We think China's economy will continue to reaccelerate in the near term. Although the country's growth rate remains below trend, we are beginning to see an improving trajectory following two and a half years of slowdown. The renminbi has depreciated steadily, and while this has not reinvigorated exports, it appears to have stopped its two-year decline. Domestic economic growth in China has been relatively stable this year; the country continues to evolve into a services-oriented economy, with that sector now accounting for more than half of GDP. Housing activity also has picked up. The question now becomes whether government economic policy flips back toward structural reform and economic rationalization and away from stimulus, given that business activity looks to be in a less fragile state than a year ago.

Before the global financial crisis, the U.S. and China were the primary growth engines of the world. Those engines are sputtering when compared to their pre-crisis performance. We think it's possible that India eventually will become a third major engine of global growth. In the past year, its GDP growth was greater than China's. While its population is nearly as large, India is growing faster and is much younger. As India institutes economic, financial and legal reforms, it has the potential to grow rapidly for a long time.

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

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

**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 MSCI All Country World 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 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 MSCI EMU Index consists of the following 10 developed-market country indexes: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal and Spain.

**The 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 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.

## Disclosures

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