

“Chimerica” Becomes a Chimera

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- The Chinese and American economies have become so intertwined that they could be viewed as one economy.
- Further ratcheting of trade tensions between the two and the possibility of unexpected Federal Reserve action are the current major threats to the bull market in U.S. equities.
- With market risks now more balanced than bullish, we believe equities still offer upside potential.

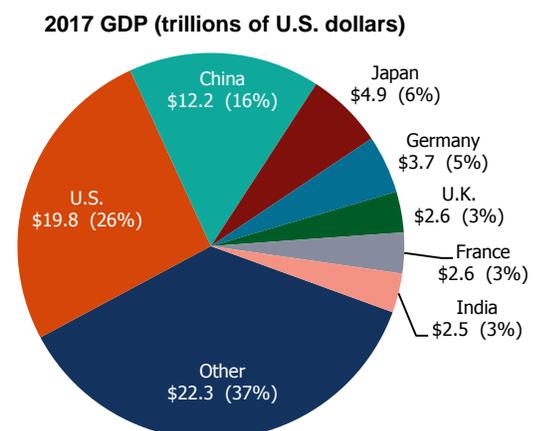
Niall Ferguson, a well-known historian and Harvard University professor, coined the term “Chimerica” in 2006. It was a clever way to underscore the fact that the Chinese and American economies had become so intertwined that they could be viewed as one economy. As Professor Ferguson pithily observed in a 2009 article, “The Chinese did the saving, the Americans the spending. The Chinese did the exporting, the Americans the importing. The Chinese did the lending, the Americans the borrowing.”¹

That symbiotic, yet unsustainable, relationship started fraying a decade ago in the aftermath of the financial crisis. The excruciatingly slow U.S. recovery from its deepest economic recession of the postwar period and economic pain sustained by those who lived in communities that lost their manufacturing base led to widespread disillusionment about the benefits of free trade. At the same time, there was a growing belief that China was no longer living up to the spirit of its World Trade Organization (WTO) agreement to open its markets to other countries in exchange for full integration into the global trading system. Subsidizing Chinese state enterprises (thereby giving them an unfair competitive advantage) and forcing foreign companies to share proprietary information and technology as a quid pro quo for market access became irritants as well. China’s muscle-flexing in the East and South China Seas in recent years added a geopolitical dimension to the rising economic tensions. The current focus is on the economic rivalry, however, as the Trump Administration imposes extensive trade tariffs and tough restrictions on Chinese investments in U.S. companies and its acquisition of intellectual property.

¹ Ferguson, Niall. “Chimerica’ Is Heading for Divorce,” Niall Ferguson (blog), Newsweek/Daily Beast, August 18, 2009, <http://www.niallferguson.com/journalism/finance-economics/chimerica-is-headed-for-divorce>.

The ratcheting-up of trade-war tensions between the U.S. and China has become the leading preoccupation of investors. And with good reason: whatever happens between the two countries will likely have global implications across economies and financial markets. As shown in Exhibit 1, China and America together accounted for 42% of world nominal gross domestic product (GDP) last year, with respective shares of 16% and 26%. No other single country came close in 2017. Even the six largest European economies combined (Germany, the U.K., France, Italy—which are shown on the chart—and Spain and the Netherlands—which are not) totaled just 17% of world GDP.

Exhibit 1:
China and America Make the World Go ‘Round



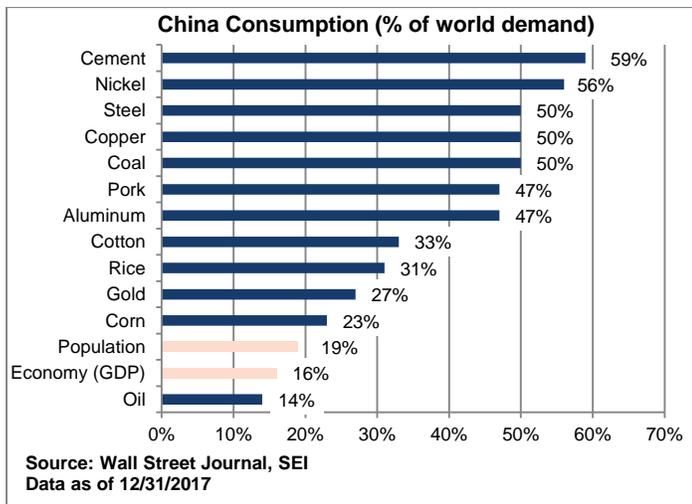
Source: Haver Analytics, Ned Davis Research, SEI
Data as of 12/31/2017

Multinational companies’ supply chains have become extraordinarily integrated in recent decades. The North American Free Trade Agreement (NAFTA), which was established in 1994, tied the U.S., Canada and Mexico in a close economic relationship that even the Trump administration was reluctant to undo despite replacing NAFTA with a new agreement. The eastward expansion of

the European Community (formerly called the European Economic Community) following the collapse of the Soviet Union in 1989 and the establishment of the eurozone in 1999 provided an economic boon to Europe. The good times ended with the 2008 global financial crisis and the 2010 debt debacle in Greece and other periphery countries. But the biggest catalyst to global growth was the 2001 accession of China to the WTO.

Even though China’s GDP per-annum growth rate has slowed to roughly 6%, the sheer size and central position of its economy in the global supply-chain network mean that the country is still the largest incremental consumer of raw commodities. As shown in Exhibit 2, China accounts for at least half of total world demand for cement, nickel, steel, copper, coal, pork and aluminum. In 2017, for example, China produced 2.4 billion metric tons of cement. India was the next largest producer at 270 million metric tons. By comparison, production in the U.S. amounted to 86 million metric tons.²

Exhibit 2: Feed Me



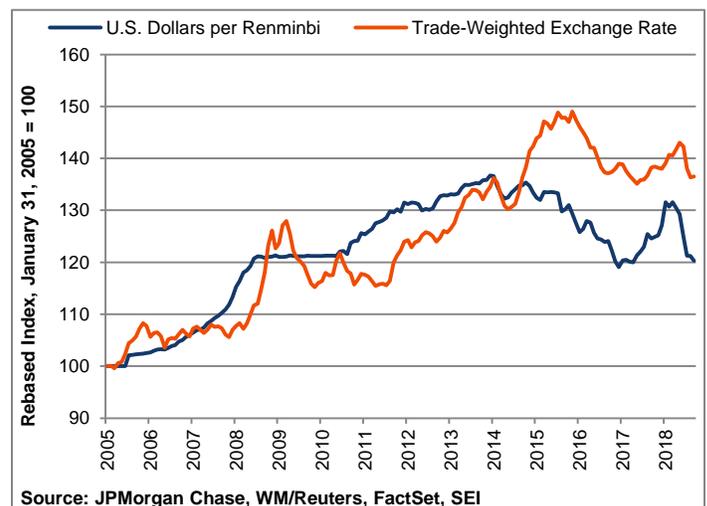
Prior to the global economic and financial crisis, China’s integration into the global economy resulted in a multi-year period of above-trend growth for the country. Its voracious appetite for raw commodities between 2002 and 2008 pressured commodity prices sharply higher, with copper prices quadrupling and oil prices quintupling. During this period, by contrast, inflation around the world was mostly well-behaved because surging exports of finished and semi-finished goods from China dampened price pressures. When economic activity fell off the cliff in 2008, world-trade contracted and China demand fell sharply too. This led to a spectacular, albeit short-lived, bust in commodity pricing.

² Van Oss, H. U.S. Geological Survey, Mineral Commodities Summary, January 2018, p. 42, <https://minerals.usgs.gov/minerals/pubs/commodity/cement/mcs-2018-cemen.pdf>

China led the world out of recession from 2008 to 2010 by virtue of an unprecedented credit-creation boom and infrastructure building-spree. As that boom dissipated, however, commodity prices again came under pressure, highlighted by the crash in oil prices in 2014 and 2015. Commodity pricing rebounded in 2016 and 2017 as the global economy enjoyed a moderate acceleration in global growth. More recently, trends have been mixed. Oil prices have climbed, but metal and agricultural prices have fallen on trade-war skirmishes, the strength of the U.S. dollar and a moderation of global GDP growth outside the U.S.

Although the Organisation for Economic Co-operation and Development’s (OECD) leading economic index for China points toward a return to trend-like growth, it is quite evident that investors remain cautious. The Chinese renminbi (also called the yuan) has fallen sharply, not only against the U.S. dollar but also against a broader basket of currencies (as seen in Exhibit 3). This began in earnest when the Trump administration’s anti-China trade rhetoric heated up in May. The renminbi has declined about 8% against the U.S. dollar from its peak, and is nearing levels last seen in 2016. The weaker currency, which reduces the cost of Chinese goods sold to U.S. consumers, partially offsets the impact of the first round of U.S. tariffs on \$50 billion worth of Chinese exports. The currency’s decline against the dollar also means that the latest round of tariffs (10% on an additional \$189 billion of Chinese goods exports to the U.S.) leaves China’s competitive position for these goods about where it was at the start of the year.

Exhibit 3: Ragged Renminbi



On the downside, the weak Chinese currency makes it almost certain that the Trump administration will increase the tariff rate to 25% at the beginning of January. It also could raise the ire of other big importers of Chinese goods, perhaps making it easier for the U.S. to enlist the support of other WTO members in its attempt to sanction China over unfair trading practices.

We expect the U.S. to continue to exert pressure on China. It now seems likely that the Trump administration will eventually impose tariffs on nearly all Chinese imports into the U.S. While the timing of this is uncertain, as is the ultimate tariff rate applied, the rhetoric coming out of the White House indicates a willingness to impose tariffs on a broader range of consumer items—from clothing to cell phones to toys, which heretofore have not been targeted. As we highlight below, the U.S. is in strong shape economically. Although nobody wins in a trade war, even White House advisors with a pro-trade bias believe that the U.S. will be the least hurt of the two countries. The relative performance of their respective stock markets suggests that investors have reached the same conclusion. While the U.S. flirts with new all-time highs, the Chinese stock market has been quite weak. The Shenzhen Stock Exchange Composite Index, which tracks performance of A and B share stocks on China's Shenzhen Stock Exchange, fell into bear territory in the third quarter—declining more than 25% from the peak recorded in late January (as shown in Exhibit 4). The MSCI China Index (price only) fell 21% in the same period.

Exhibit 4: Bear Country

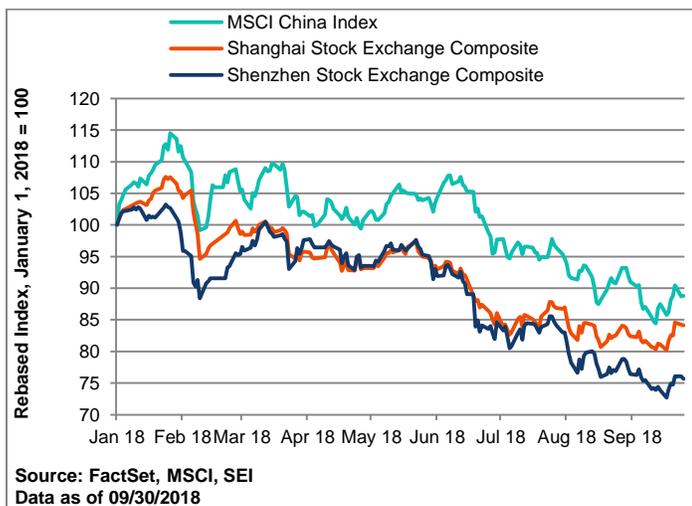


Exhibit 5 shows that China makes up more than 31% of the MSCI Emerging Markets Index. South Korea and Taiwan—highly industrialized countries that are nevertheless still in the MSCI Emerging Markets Index—account for another 26% of the emerging-market benchmark. Both countries are heavily dependent on trade with China, according to data tracked by the International Monetary Fund; South Korea's exports to China totaled 11.8% of its GDP as of the first quarter, while Taiwan's exports to China were the equivalent of 30% of GDP. Other Asian countries that are critically dependent on trade with China, as measured by percent of GDP, include Malaysia (15.3%), Thailand (8.5%) and the Philippines (6.5%). Non-Asian countries that export the equivalent of more than 5% of their GDP to China include South Africa, Chile and Peru. As Exhibit 6 makes clear, however, stock-

market performance is not totally correlated with the degree of trade dependence with China. Despite escalating trade tensions and signs of slowing in China's economy, Taiwan, Thailand and Malaysia have shown great resilience in the year to date in U.S. dollar terms.

Exhibit 5: Watch Your Weight

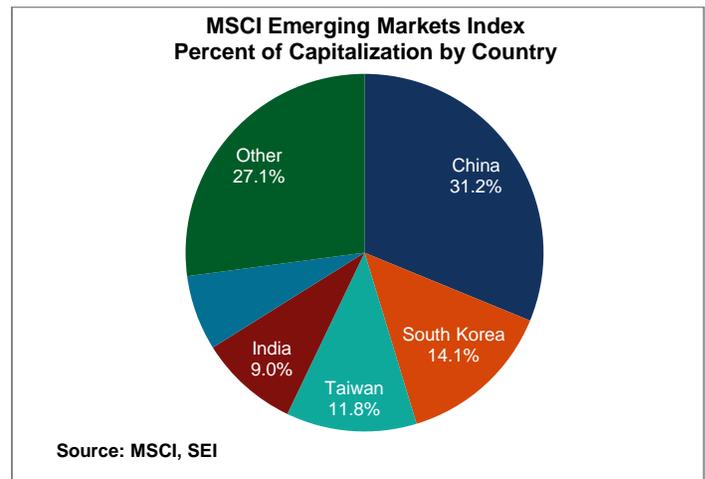
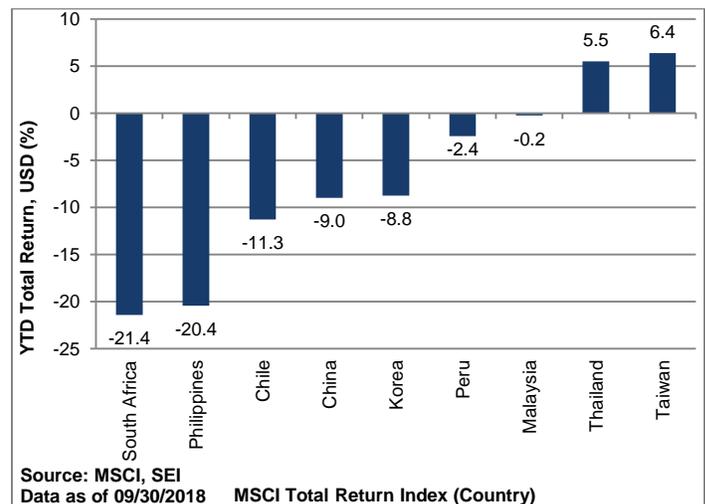


Exhibit 6: China Conundrum



Although the near-term view is fraught with uncertainty, we still believe that emerging-market debt and equity have roles to play in a diversified portfolio. While emerging markets are typically more volatile than their developed-country counterparts, they tend to provide higher growth and greater diversification over time. The alpha opportunities (that is, the ability to achieve return in excess of benchmarks) also are much greater, given the economic and political idiosyncrasies inherent in the asset class. Over the past 30 years, the MSCI Emerging Market Index (Total Return) has performed as well as the MSCI USA Index. Emerging markets have lagged in recent years, but there is good news in this poor performance: The price-to-earnings ratio has been running at about a 30% discount to that of the U.S. stock market. That discount approaches

the attractive relative valuation levels last seen in early 2016.

We view the imposition of tariffs as a negative for growth, inflation and corporate profitability, yet it is not at all clear how much of a negative effect it will have. There are a lot of moving parts to consider. For example, China may choose to continue to devalue its currency in order to maintain its competitive edge. However, there are alternatives to renminbi devaluation. If a Chinese company or China-based subsidiary of a multinational business exports a critical intermediate component or a much-desired consumer product, for example, the cost of the tariff will likely be borne mostly by the U.S. buyer. If the item produced enjoys a high profit margin, the importing company might instead absorb most of the extra cost. Low-tech goods with narrow profit margins (such as shoes and clothing) might need to be made elsewhere, in a low-cost locale like Vietnam, Bangladesh or Laos. How quickly supply chains can be relocated will be a critical factor, either exacerbating or tempering the tariff impact on consumers and companies in both the U.S. and China. It will depend on the complexity of the manufacturing process, the ability and educational level of the local workforce, and the available capacity and infrastructure of the potential host country.

Asia represents nearly two-thirds of SEI's emerging-markets equity portfolios, the largest regional exposure. While a meaningful allocation, we are underweight to the area—within which the most significant country underweights are to China, Korea and Taiwan. We maintain a positive long-term view on China; our underweight to the country is tempered by its place as the largest country weight in absolute terms. As for frontier markets, we have exposure to Vietnam, Argentina, Bangladesh, and Sri Lanka. Total frontier-market exposure is around 13%. Within Latin America, we are underweight Brazil and Mexico (the two biggest countries within the region). In addition to Argentina, overweights include Peru and Colombia.

Our structural underweight to certain countries influences our sector positioning versus the benchmark. As a result of an underweight to technology-heavy Asian markets such as South Korea and Taiwan, information technology is underweight despite it being the second largest sector from an absolute point of view. Industrials are overweight. We also favor consumer staples and healthcare, the latter being a small sector within the universe. Both should benefit from the rapidly expanding middle class in developing countries.

In fixed income, our emerging-market portfolios have reduced exposure to local-currency debt to below market weight. Our foreign-exchange exposure remains the same on the belief that the hard-currency market is nearing its bottom. We continue to be heavily overweight to Argentina in both local- and hard-currency terms; hard-currency

exposure includes euro-denominated bonds that offer wider spreads than those denominated in U.S. dollars. We are underweight the low-yielding countries such as the Philippines and Malaysia.

In Search of a Separate Peace

As the trade war with China heats up, the Trump administration has turned more conciliatory toward other countries with which it has picked fights. The threat of tariffs on European and Japanese autos and auto parts, for example, has been taken off the table. This may be a temporary truce, but we are hopeful that it represents a realization by the White House that it's better to gain allies in its battle against China than fight on multiple fronts.

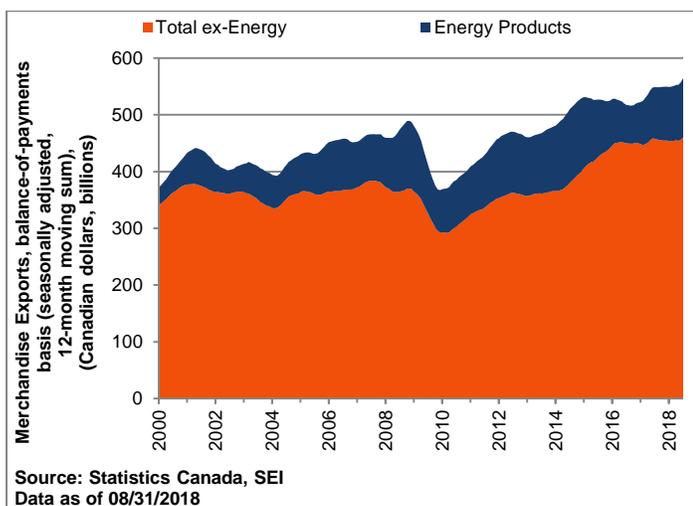
With regard to NAFTA, the new US-Mexico-Canada Agreement (USMCA) that replaces NAFTA provides trilateral agreement with Mexico and Canada on major items such as increased North American and U.S. content in automobiles and the maintenance of zero tariffs on agricultural products. Discussions with Canada reached a dramatic resolution at quarter's end, overcoming major sticking points including the adjudication of trade disputes, the unilateral imposition of tariffs, and Canada's restrictive agricultural trade practices (especially as it applies to dairy products).

The Canadian dollar has weakened against both the U.S. dollar and the Mexican peso this year, perhaps reflecting concern that a revised NAFTA agreement would not be reached with the Trump administration. NAFTA supporters worried that a breakdown in negotiations would lead to punitive tariffs on Canadian autos and auto parts, harming companies on both sides of the border. We are relieved that a middle ground was reached because a severe disruption to trade would have been in no one's economic interest.

The U.S. and Canada are each the other's biggest export market. Since the latter country is much smaller, however, it would sustain a larger economic hit to overall economic activity in a trade war. In total, Canada sent more than 75% of its exports to the U.S. last year, according to Direction of Trade Statistics from the International Monetary Fund database. Exports to China (4.3% of total Canadian exports), the U.K. (3.2%), Japan (2.2%) and Mexico (1.4%) lag far behind. Mineral fuels, oils and distillates make up one-fifth of Canada's exports. But the real pain would be felt in the auto and auto parts sector, which make up 15% of the country's total exports.

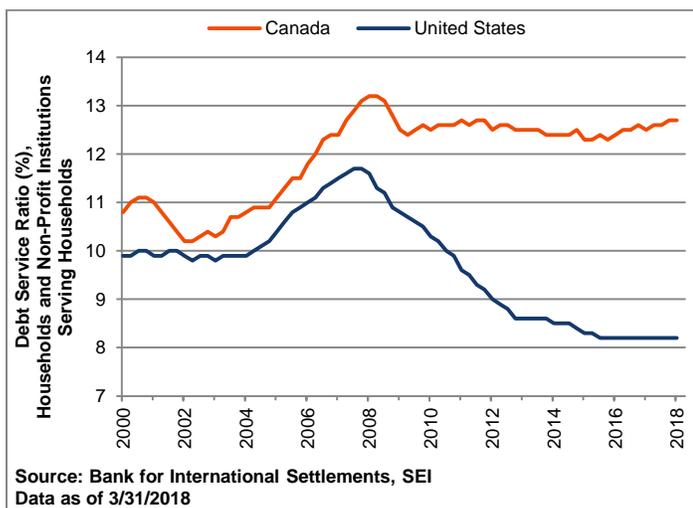
Canadian exports have been relatively strong thus far in 2018 despite the imposition of tariffs on aluminum and steel by the Trump administration (as shown in Exhibit 7). Most of the incremental improvement has come from the energy sector, however, which has benefited from the rebound in oil prices over the past two years. Excluding energy, the trend in exports has been modest since the start of 2016.

Exhibit 7: Is Winter on its Way?



Although the Canadian economy is doing reasonably well compared to other developed countries on a real GDP basis, growth has been losing steam in the past year. We remain particularly concerned about the leveraged position of the household sector. Debt service-to-income ratios remain highly elevated relative to households in the U.S. and to its own history (as shown in Exhibit 8). The global financial crisis a decade ago did not hit the Canadian economy as hard as it did elsewhere. As a consequence, households in Canada did not adjust their borrowing behavior. Although tighter mortgage rules and higher interest rates may reduce demand for loans, debt-service-to-income ratios in Canada will likely remain elevated as rates on existing mortgages adjust upward.

Exhibit 8: Canadians' Borrowing Binge May Cause a Hangover

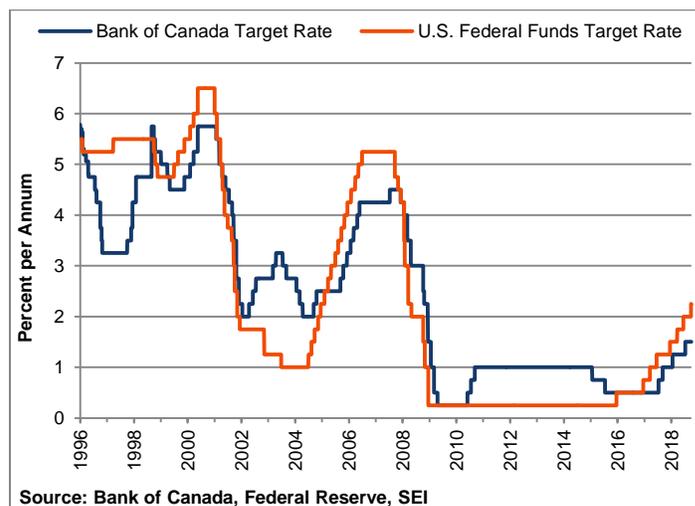


We believe that the household sector is the key vulnerability that forced the Trudeau government to make more concessions on trade with the U.S. than it would have liked. The auto industry is too important to its

economy to allow a major disruption. According to the Canadian Vehicle Manufacturers' Association, Canada exported C\$63 billion worth of vehicles in 2016, 97% of which went to the U.S. Direct car-industry employment in Canada is roughly 130,000. When jobs that depend on the car industry (such as dealerships) are included in the figure, the total balloons to 500,000. Auto and auto-parts production account for more than 1% of Canadian GDP.

In the worst-case scenario of a U.S.-Canadian trade war, tens of thousands of Canadian auto and auto-related jobs would have been in jeopardy—at a time when household incomes are being squeezed by rising interest rates and inflation that is slightly above the Bank of Canada's 2% inflation target. Exhibit 9 shows that the Canadian central bank tends to shadow the U.S. Federal Reserve's (Fed) policy moves. In the end, Canada averted the crisis.

Exhibit 9: Me and My Shadow



SEI's Canadian equity portfolio remains overweight value, underweight momentum and neutral stability on a factor basis. Overweight sectors include consumer staples, consumer discretionary, industrials and information technology. Financials and energy remain the largest underweights, followed by healthcare, materials, utilities and telecommunications. Fixed-income strategies remain cautious on the rate outlook, with the portfolio's duration (that is, sensitivity to interest-rates movements) less than benchmark.

A Game of Chess over Chequers

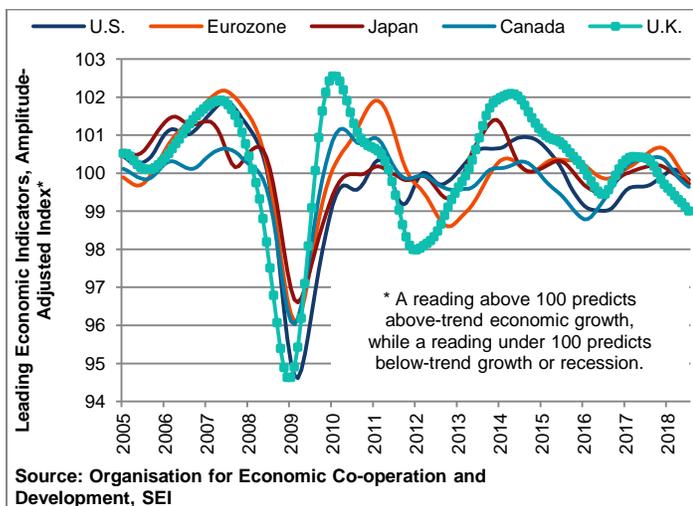
As mentioned above, President Trump gave Europe a reprieve on trade. It's a good thing, since the Continent already has enough economic and political challenges on its plate. Brexit discussions with the U.K. are reaching a crucial stage as the March 2019 formal departure of the U.K. from the EU draws ever closer. Meanwhile, radical political parties Lega and Five-Star that have gained power in Italy threaten to burst the fiscal constraints that all EU members are obligated to follow. And then there are the

business-as-usual problems: sluggish economic growth, still-high unemployment, and the never-ending disagreements over how expansive monetary policy should be.

In terms of trade, the U.K. is to the EU as Canada is to the U.S. As an export market, the U.K. is far more dependent on the EU than the other way around. About 44% of U.K. goods and services were exported to other EU countries in 2017. On the other side of the trading ledger, 53% of U.K. imports came from other member states. From the EU perspective, only 18% of its total exports go to the U.K.—on par with the percent of goods and services exported to the U.S. Scaled to the size of their economies, U.K. exports to Europe equaled 13.4% of U.K. GDP, while EU exports to the U.K. amounted to roughly 3.5% of EU GDP for the 2017 calendar year.

A hard Brexit (in which the U.K. gives up access to the benefits of conducting business with members of the EU as a single trading block in exchange for the ability to opt out of the EU's open-border immigration policy) would leave the trading relationship between the former partners at the lowest common denominator of most-favored-nation status, as specified by WTO rules. This would put the U.K. at a distinct disadvantage in agricultural products because EU tariffs on food products are especially high. It also would severely affect the U.K.'s export of financial and other services (keep in mind that manufacturing accounts for only 10% of the U.K.'s GDP, while services account for 80%). Although a last-minute agreement or a mighty kicking of the can down the road is possible, widespread fear of a hard Brexit can be seen in the economic data. The OECD's Leading Economic Indicators, depicted in Exhibit 10, shows that the U.K. has experienced the most dramatic deterioration of the world's major developed economies.

Exhibit 10: Follow the Leaders

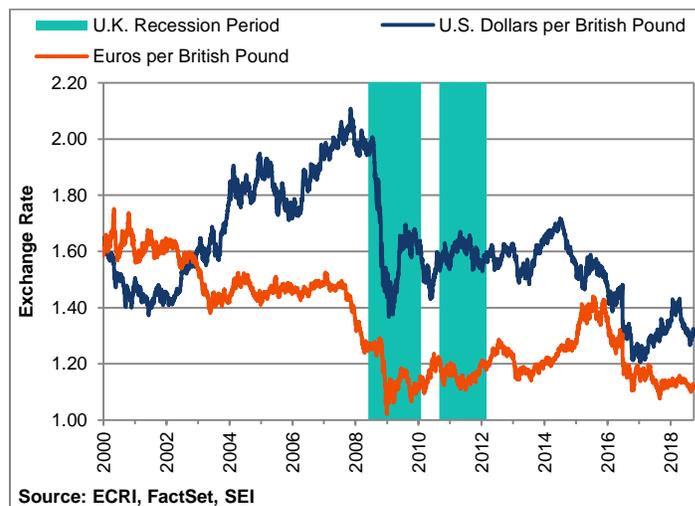


Investors continue to debate whether the U.K. currency adequately reflects the prospects of a hard Brexit. Sterling

has weakened significantly in recent years, although it enjoyed a sharp recovery against the U.S. dollar in 2017 after the shock of the June 2016 Brexit referendum vote played out (as shown in Exhibit 11). The euro also rose against the U.S. dollar in 2017, so sterling did not show the same vibrancy against the euro cross-currency.

Considering how far pound sterling has sunk already, it's not easy to call for further weakness—yet a number of factors above and beyond the unknowns of Brexit could lead to such a result. Political uncertainty, for example, is on the rise. The plan that Prime Minister Theresa May put forth during a meeting at Chequers, her official country residence, was given a frosty reception by the EU and by her pro-Brexit rivals within the U.K.'s Conservative Party (who seem increasingly eager to replace her). Inflation is also showing signs of acceleration. If the Bank of England falls behind the curve in normalizing interest-rate policy, traders could sell the currency. Finally, considering how weak sterling was during the global financial crisis, it surely cannot be described as a safe-haven currency in times of economic tumult.

Exhibit 11: Cheaper by the Pound

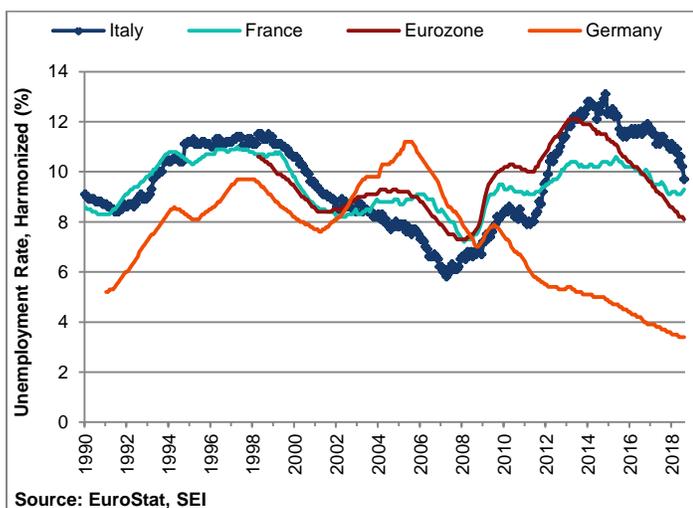


As if the future departure of the EU's second-largest member isn't bad enough, the eurozone is grappling with a number of other issues, both economic and political. The most concerning is Italy's increasingly antagonistic relationship with the bureaucracy of Brussels, Belgium (the de facto capital of the EU). Italian bond yields have risen sharply higher this year as the Lega/Five-Star coalition pushes for spending programs and tax changes that would worsen the country's already-strained fiscal position. Although the situation remains fluid, there is hope that the coalition will temper its ambitious program, holding the central government's deficit below 2% of GDP and keeping the bond vigilantes at bay. The coalition, however, wants to make good on some of its campaign promise and is fighting to raise the deficit ratio to a level that's closer to 2.5% of GDP. Italy is likely to be at loggerheads with the

rest of the eurozone for years to come. If the Lega/Five-Star coalition's fiscal wish list were put into full effect, the country's deficit would soar well beyond the 3%-of-GDP maximum allowed under the EU's Stability and Growth Pact.

Italy is the third largest eurozone economy, behind Germany and France. It has the fourth largest debt-to-GDP ratio in the world, behind Japan, Greece and Portugal. To say the least, a debt crisis in Italy would not be as easy to handle as the Greek one (which wasn't all that easy). The brutal fact of the matter is that Italy has been hamstrung by an uncompetitive currency since its inclusion in the eurozone. Industrial output is no higher now than it was in the 1990s. The country's headline unemployment rate has improved only marginally, lagging the performance of Germany, France and the overall Eurozone (as shown in Exhibit 12). It should not be surprising that the Italian electorate has run out of patience with the establishment parties and wants to try something new—even if that new thing is politically chaotic and economically incoherent.

Exhibit 12: Roma in a Coma



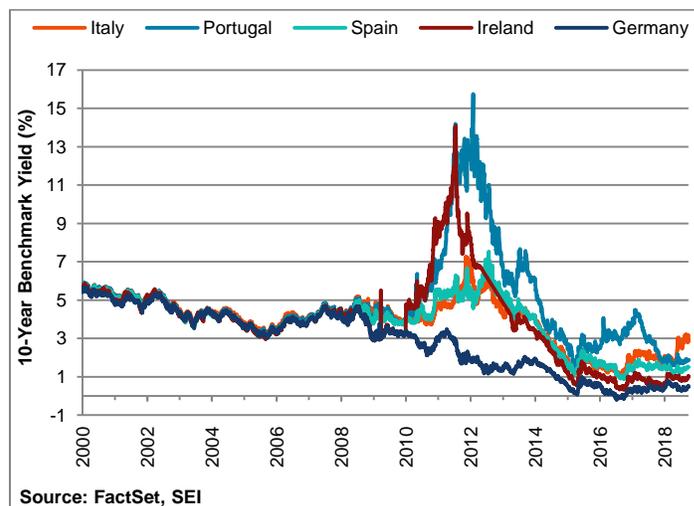
A complicating factor for Italy and other highly-indebted countries, including Portugal and Spain, is the tapering of asset purchases by the European Central Bank (ECB). According to a study by the Center for European Economic Research (ZEW), a Germany-based think tank, the share of Italian bonds purchased by the ECB under the Public Sector Purchase Program (PSPP) equaled 17.7% of its GDP since the start of the program in March 2015, higher than the 14.4% average for the eurozone as a whole.³ Since the PSPP's inception, the ECB's purchases of Italian bonds equate to 53% of the country's cumulative deficit as of July 2018. As is the case in the U.S., where the Fed has

³ Heinemann, F. (2017) ZEW News, <http://ftp.zew.de/pub/zew-docs/zn/en/zn1122017.pdf>

begun to reduce its holdings of securities, Italy will be losing a large, price-insensitive (not to mention risk-insensitive) buyer of its bonds at an inopportune time.

The ECB is set to finish its taper at the end of the year. Mario Draghi, the central bank's president, has ruled out any move toward reducing its assets outright (as the U.S. has been doing since last October). ECB watchers are looking for the first policy rate hike about a year from now. Since Draghi's term is over at the end of October next year, we think he may leave policy rate normalization to his successor if there is any lingering doubt about the sustainability of the eurozone's economic expansion. He does not want to repeat the mistake of Jean-Claude Trichet, Draghi's immediate predecessor. Trichet raised short-term rates in April and July 2011 despite the obvious dangers presented by the periphery debt crisis. Bond yields were already soaring by the time the ECB made its first tightening move, as shown in Exhibit 13.

Exhibit 13: Prelude to a Periphery Repeat?



The current economic backdrop is not nearly as dire as it was back then. Nonetheless, economic activity during the first half of 2018 was well off the pace enjoyed during 2017, and the signs are pointing to an annualized pace of about 2% GDP growth in the quarters immediately ahead. Industrial-production growth has been slowing progressively throughout the year. Export growth has been particularly weak, reflecting the slowdown in China and a decline in exports to the U.K. The lagged impact of the euro's sharp appreciation in 2017 is another factor depressing the export sector.

On the positive side, few worry about the possibility of deflation. Core inflation remains stuck around 1%, but that's an improvement from a few years ago when year-on-year price gains were closer to 0.6%. In any event, we need to keep an eye on the fiscal position of Italy and the smaller periphery countries since the weakest nations will feel the greatest pain as the global economy slows.

SEI's U.K. and European equity portfolios are positioned somewhat cautiously. Stability-oriented strategies continue to have a low allocation, owing to valuation concerns. Value-oriented positions have been trimmed and reallocated to momentum strategies. Sector-wise, consumer discretionary and industrials are the largest overweight positions due to attractive valuations. Information technology also represents a significant overweight. Underweights include energy, materials and healthcare. A structural underweight to energy is primarily driven by the sector's large weighting in the benchmark. In Europe outside the U.K., industrial stocks are the biggest overweight, followed by energy. Underweight sectors include consumer staples and utilities.

SEI's global bond strategies maintain a pro-cyclical tilt. Our largest position is an underweight to U.S. duration. Credit remains expensive. We prefer financials and shorter-dated credit.

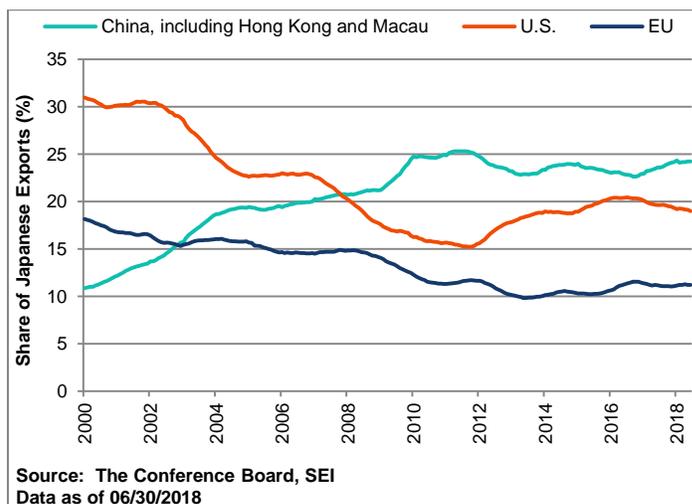
Japan Grinds Along

The Japanese economy, as measured by real GDP, continues to expand at a sedate pace. The economy grew 1.3% over the four quarters ended June. The April-to-June period recorded a seasonally adjusted annual rate of 3% growth, but this followed an outright decline in the first quarter. Capital spending has been a bright spot, but has been offset by a sluggish consumer.

Trade-war concerns are near the top of Japan's worry list, given the country's export-heavy orientation and its equally important relations with China and the U.S. The share of Japanese exports going to China has picked up in recent years, while the share headed to the U.S. has declined (as seen in Exhibit 14). A poll of leaders from 114 major Japanese companies conducted by Nikkei Shimbun in late August and early September showed that more than 60% of those surveyed expected their earnings to suffer from a trade war.⁴ Products from 17% of these Japanese companies already have been subjected to higher U.S. tariffs and retaliatory actions by other nations prior to September. That percentage has increased further with the imposition of tariffs on additional Chinese exports to the U.S. The poll noted that seven Japanese companies have already relocated production or switched suppliers, while another 15 are considering similar moves. In all, Japanese companies generated \$218 billion in revenue from overseas production sold outside of Japan and that country of origin, according to Japan's Ministry of Economy, Trade and Industry. Outsourcing to China accounts for \$26 billion, or 12%, of that total.

⁴ Ohira, Yugi. (2018) 'Trade war likely to hurt profits for 60% of Japan's top companies,' *Nikkei Shimbun* (online), September 11, 2018, <https://asia.nikkei.com/Economy/Trade-War/Trade-war-likely-to-hurt-profits-for-60-of-Japan-s-top-companies>

Exhibit 14: Japan Treads Carefully



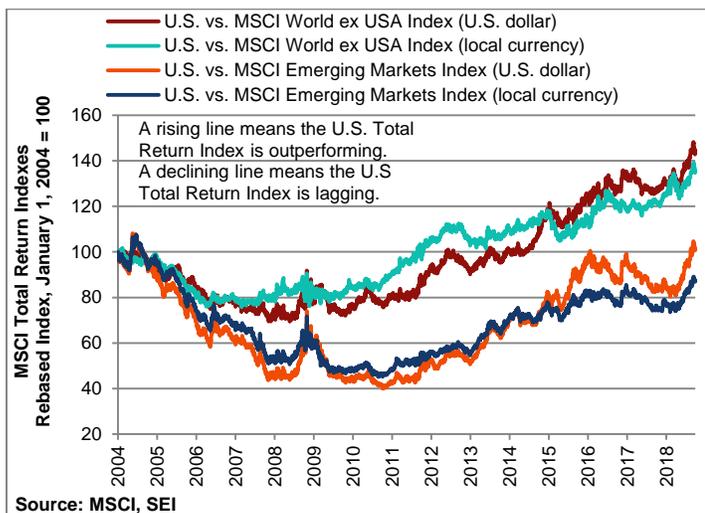
The Bank of Japan (BOJ) is seeking ways to protect the domestic economy from the possible fallout of reduced trade flows. We wonder how effective it would be if the worst came to pass. The yield curve is still negative out to six years, although it has steepened dramatically since the end of the second quarter. In July, the BOJ widened the band in which the 10-year Japanese government bond yield could trade—from 10 basis points (0.1%) to a spread of 20 basis points above or below the zero mid-point. It doesn't sound like much but it's better than nothing. In any event, it's clear that the central bank will keep its "quantitative and qualitative easing with yield curve control" program in place for a long time to come. It may not deliver exceptional economic growth or inflation even remotely close to the BOJ's target of 2%, but it probably should prevent deflation from taking hold.

In terms of Japanese equities, we favor value and momentum strategies. We also have a bias toward small- and mid-cap stocks.

The U.S. Is Still the Shining Light on the Hill

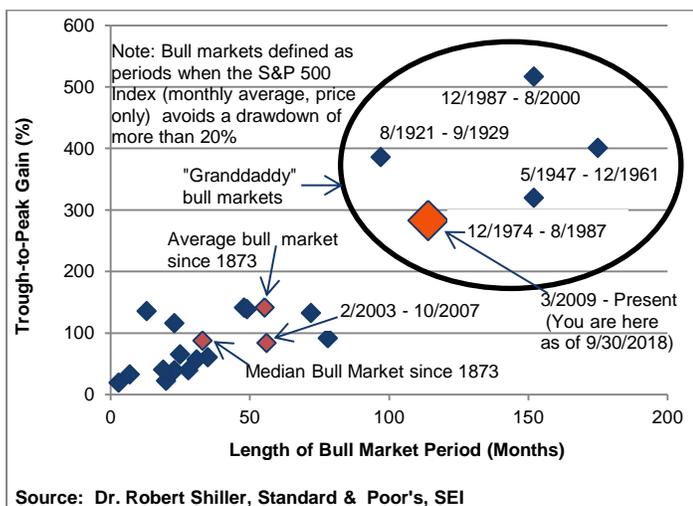
It's been quite a run for U.S. equities for much of the past nine years. As Exhibit 15 highlights, the relative performance of the U.S. against other developed-country stock markets (MSCI World ex USA Index) as well as developing markets (MSCI Emerging Markets Index) has been stellar, whether the yardstick is in U.S. dollar or local-currency terms. Remarkably, the relative performance of U.S. equities since the end of last year has been one of the best yet during this long span (notwithstanding a pullback in recent weeks).

Exhibit 15: The U.S. Powers Ahead



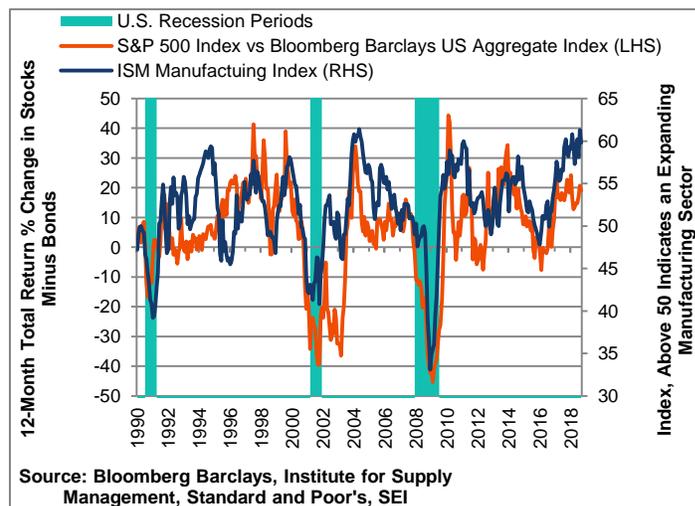
Some proclaim this to have been the longest U.S. equity bull market in history. However, in an effort to put this powerful performance into historical context, we calculated past S&P 500 Index performance using monthly averages instead of daily closings or intraday highs and lows (as shown in Exhibit 16). On that basis, the current bull market is definitely one of the longest on record at over nine years, surpassing the 1921-to-1929 experience. However, it still falls short of three other “granddaddy” bull markets, which we highlight in the oval below. The longest bull market without a 20% decline lasted from May 1947 to December 1961, well over 13 years. In terms of magnitude, the longest bull market of all time registered a price-only gain of 400%. The prize for the biggest price-gainer goes to the bull market that started in December 1987 and lasted through August 2000. The S&P 500 Index (price only) advanced by more than 500%. By comparison, the current bull has recorded a cumulative price-only gain of “just” 280% through September.

Exhibit 16: This Bull Makes the “Granddaddy” Grade



The current bull market is old, but there’s little reason to expect it to keel over. The fundamental outlook remains favorable for U.S. equities despite trade-war concerns and the rising trend in interest rates. Exhibit 17 compares the total return on the S&P 500 Index versus that of the Bloomberg Barclays US Aggregate Bond Index (measured as the percentage difference in performance between the two asset classes over 12-month rolling periods), and compares that performance against the ISM’s manufacturing index. There is a strong positive correlation, with superior stock-market performance relative to fixed-income corresponding with economic strength. The ISM’s manufacturing index hit a new high for this expansion, of 61.3 in August, and remained strong in September with a reading of 59.8; the total return of the S&P 500 Index over the past 12 months, meanwhile, has beaten the Bloomberg Barclays US Aggregate Bond Index by 20 percentage points.

Exhibit 17: Economy Gives Green Light for Equities



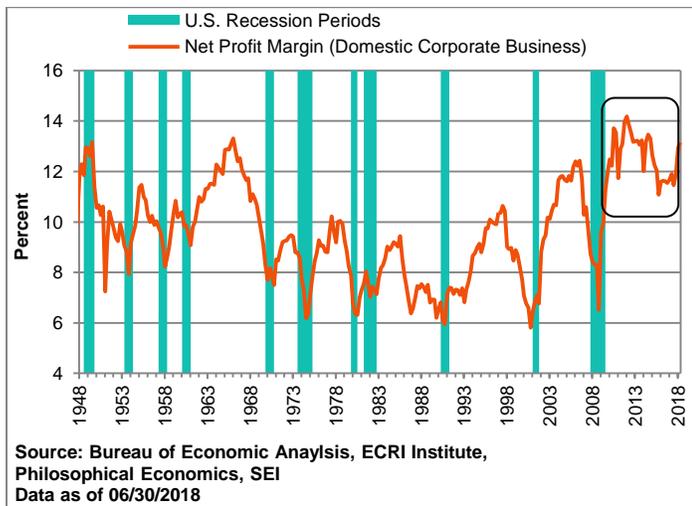
The high ISM reading as of August is unsustainable, but a pullback in the manufacturing index would need to be substantial—falling from its current level of 59.8 to a level much closer to 50—before it would correspond to a prolonged period of stock-market weakness relative to bonds. We figure that the odds continue to favor equities given the still-low level of bond yields (the yield to maturity on the U.S. aggregate bond is approaching 3.5%) and the likelihood that the total return on bonds will be slightly less than its yield over the next 12 months (reflecting a weakening in bond prices as yields rise). If the earnings multiple on stocks stays about where it is currently (nearly 17 times the earnings estimated one year ahead), it’s possible that the S&P 500 Index will record a total return close to 10% over the next 12 months.

Of course, there are a number of moving parts behind this best-guess scenario. Equity-market performance could be constrained, for example, if analysts’ earnings estimates fade in the event that economic growth slows unexpectedly or profit margins falter as a result of the

increasing tariffs on tradable goods. The multiple on those estimated earnings also could fall if interest rates climb at a faster-than-expected pace, or if leading indicators of the economy begin to point toward recession in 2020. That said, we still think it's premature to turn negative on the near-term outlook given today's mosaic of economic fundamentals. SEI views the risks to the U.S. stock market as evenly balanced and not yet tilted to the downside.

Tax cuts, deregulation and strong revenue growth have provided an ideal backdrop for U.S. equities to appreciate even in the face of China tariff tensions and the generally poor performance of international stock markets. Exhibit 18 highlights the net profit margin of U.S. domestic corporations, as measured in the GDP accounts. Two things stand out in this chart. First, U.S. companies have benefited from unusually high margins. Economy-wide corporate earnings have fluctuated between 12% and 14% of sales since rebounding from the financial crisis a decade ago. The multi-year persistence of these high margins is unusual. Second, profit margins have spiked higher in the past two quarters, reflecting the impact of the tax cut and the acceleration of sales growth. In the latter stages of an economic expansion, margins normally contract on a sustained basis as higher costs for labor, interest-expense and depreciation take a larger slice of the pie. Profits, of course, are still mean-reverting and are tied closely to business-cycle developments. Eventually, overall earnings will head lower, led by the trend in margins. A sustained deterioration in margins over three or four quarters toward about 10% to 11% would be a warning sign that a recession is on the way.

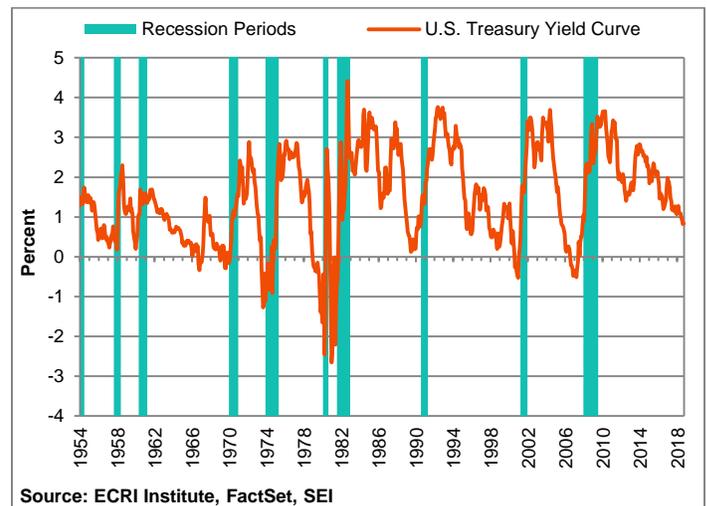
Exhibit 18: A Margin Miracle



Whenever we discuss the early warning signs of recession, we highlight the yield curve since it has been one of the more accurate leading indicators of an impending recession. Exhibit 19 shows that the spread between 3-month and 10-year Treasuries has been narrowing throughout much of the expansion from an exceptionally wide starting point back in 2009. In recent

months, the spread has shrunk to less than one percentage point (currently about 0.8%, or 80 basis points). As the chart shows, when the spread is hovering between 50 and 100 basis points, a recession is usually still two or three years in the future. If short-term interest rates continue to rise faster than bond yields, however, the odds of recession climb. By the time the yield curve either narrows to 25 basis points or inverts (that is, when short-term rates rise above long-term rates), a recession could begin within the next 12 to 18 months. The only time a recession did not develop after the yield curve inverted was the 1966-to-1967 period, when U.S. economic growth slowed dramatically.

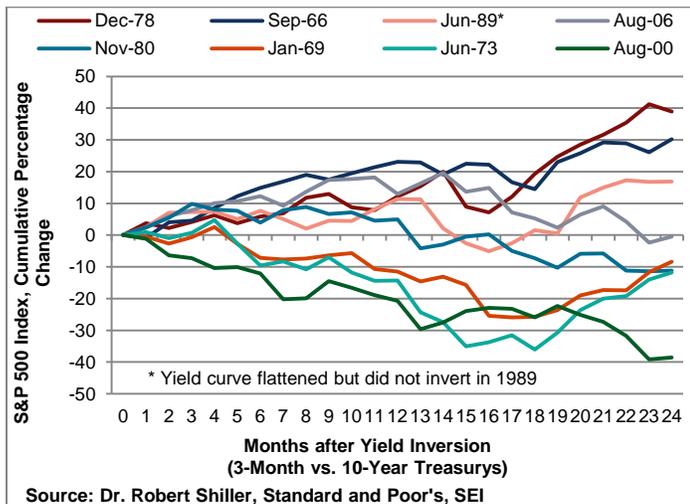
Exhibit 19: Watching the Curve Swerve



The stock market itself also is considered a leading indicator, since the start of a bear market in equities usually precedes an economic downturn and the next bull market has its genesis before the economic recession ends. But what is the relationship of a yield-curve inversion to stock-market performance? The answer can be found in Exhibit 20, which shows the price-only performance from the date the yield curve inverts over the following two years. We include the near-inversion of June 1989 because a recession followed in August 1990, when oil prices were spiking in response to the invasion of Kuwait by Iraq that kicked off the first Gulf War.

Exhibit 20 also underscores that there is no hard-and-fast rule concerning how stocks react when the yield curve inverts. There were only three instances of stocks slumping immediately after the yield curve inverted, in 1969, 1973 and 2000. In the other periods when the yield curve inverted, the S&P 500 Index (price only) managed to post gains between 4.5% and 19.5% over the following 12 months. The two-year periods following each yield-curve inversions generally recorded cumulative declines; however, note that two out of the five bears had already hit bottom and were in a recovery phase within two years of the inversion.

Exhibit 20: Curve Inversion, Equity Dispersion



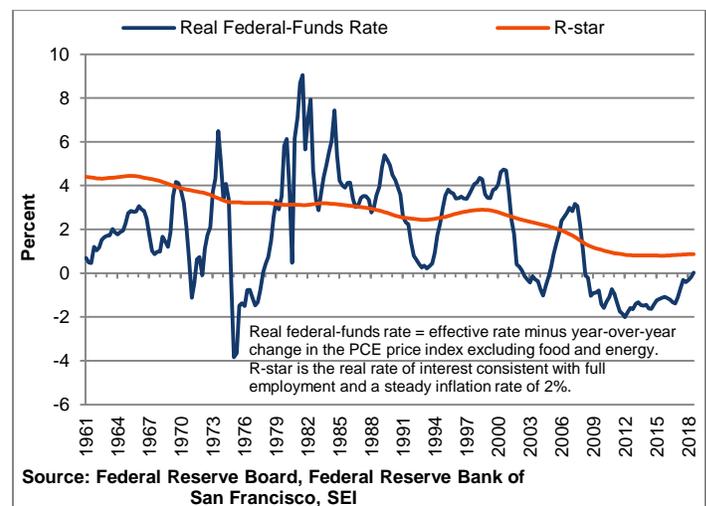
Every instance is unique. Deeper recessions usually cause sharper share-price declines (as was the case in 1973), as do more expensive stock markets (as seen following the 1998-to-2000 tech bubble). Market booms can lead to market busts. A final point: the time between an initial yield-curve inversion and the emergence of a bear market can be extremely long. The yield-curve inversion of August 2006, for example, was not accompanied by a big bear market within the two-year time frame we have been considering. However, we all remember how bad things got soon thereafter.

We see two major threats to the bull market in U.S. equities. The first would be a further ratcheting of trade tensions with China that jeopardizes the profitability of multinational corporations. As we pointed out above, however, the ultimate impact on U.S. economic growth, inflation and overall profitability is hard to fathom at this point. If the trade war becomes more consequential, it's evident that investors see the U.S. economy as more resilient than most given the sharp outperformance of U.S. equities versus the other developed and emerging markets.

The other major threat is a more traditional culprit: the Fed. Few observers would dispute that the central bank will likely continue to raise interest rates in the near-term. The question is how high the federal-funds rate will ultimately go, and whether that level proves to be sufficient to keep inflation near the central bank's 2% target or turns out to be overkill. This is a tricky time for the Fed's policy makers. With the economy close to full employment, causing wages to drift modestly higher, they have some incentive to keep raising the funds rate.

In Exhibit 21, we illustrate the real (inflation-adjusted) federal-funds rate versus the "R-star," or neutral, rate favored by some Fed policymakers. The R-star measure is a theoretical construct that is supposed to be consistent with a steady 2% inflation rate and full employment, the central bank's two legal mandates. Fed Chairman Jerome Powell has been pointedly unimpressed with the R-star measure even though it is currently consistent with the central bank's consensus view of where the funds rate should end up in the longer run. At the moment, the R-star measure suggests that a real (inflation-adjusted) federal-funds rate of 1%. This equates to 3% with inflation. The current federal-funds rate still is one percentage point below that level, even after the most recent policy rate hike on September 26.

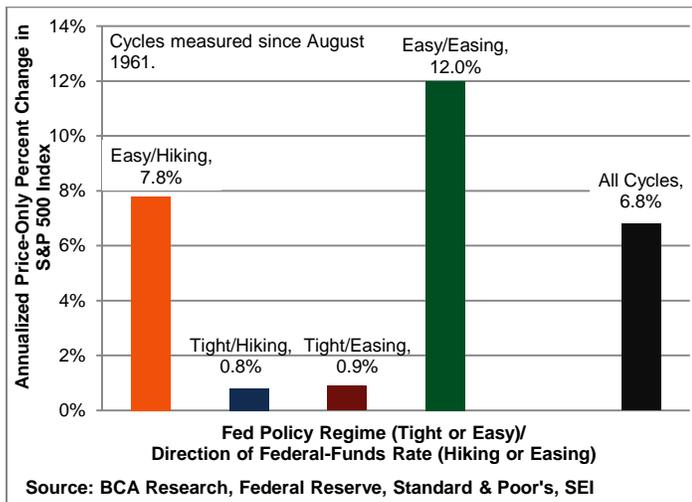
Exhibit 21: Reaching for the R-Stars



We agree with the Fed's view that the federal-funds rate is still below the so-called neutral rate of interest. Additional rate hikes appear appropriate. What does this mean for U.S. equities? Independent investment research company BCA Research recently looked at the performance of the S&P 500 Index since 1961 under four different scenarios.⁵ It found that equities do best when monetary policy can be considered easy (that is, the actual federal-funds rate is below the neutral rate) and the Fed is reducing interest rates (Exhibit 22). On balance, stock prices have appreciated more than 12% per annum at that stage of the cycle. When monetary policy is easy but the funds rate is moving up (the current situation), equity prices have risen nearly 8% per annum. It's only when the Fed continues to raise rates after reaching the neutral rate that the stock market runs into real trouble.

⁵ Peta, D. (2018) *Revisiting the Fed Funds Rate Cycle*. <http://www.bcaresearch.com>

Exhibit 22: Rates Are Rising, but Fed Policy Isn't Tight



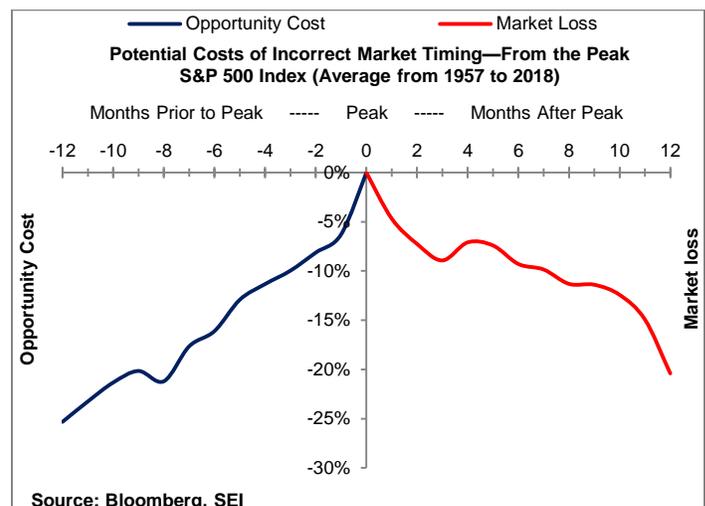
We remain generally positive on the outlook for U.S. equities, even at this late stage of the economic cycle. One can argue about whether the valuations embedded in the U.S. equity market is high, especially when measured against other global stock markets, although earnings growth in the latter has been less robust. The extreme appreciation in some large technology companies also suggests that the U.S. stock market could be subject to a sharp rotation from previous winners to the laggards somewhere down the road. SEI equity portfolios certainly tilt in the direction of more value-oriented companies and industries.

Predicting the future is a hazardous venture most of the time. In view of the uncertainties facing investors at the present time, the prediction game is, perhaps, even more challenging. Accordingly, we believe in a diversified approach to investing. Although maintaining exposure to risk assets may feel uncomfortable, we believe that investors with long time horizons can benefit from keeping in mind that mistiming entries and exits into and out of equities can be costly.

Today, mistiming an exit is the greater concern. Exhibit 23 illustrates the potential cost of missing the market peak: selling out before the market peak can lead to an opportunity loss (the gains that are foregone), while selling after the peak leads to actual losses. Since 1957, the S&P 500 Index has, on average, performed well in the final year

of each bull market. If an investor sold stocks 12 months too soon (that is, before the peak in prices), the opportunity loss would average nearly 25%. If stocks were sold one year after the peak in prices, the realized market loss would average 20%. This exercise doesn't even consider the opportunity or actual losses sustained in the process of picking the bottom of a bull market when re-establishing equity exposure. The effort to correctly guess both the right time to sell and the right time to repurchase comes with risks of its own.

Exhibit 23: Investors Often Eat a Broken Crystal Ball



SEI's large-cap portfolios maintain a value tilt. Financials and healthcare are the largest overweights, while technology is heavily underweight. Small-cap equity portfolios have been shifting from momentum strategies into value. Absolute weightings are little changed, however, owing to the outperformance of momentum stocks.

In fixed-income, the themes of SEI's core portfolios have not materially changed. Duration is near a neutral setting. Portfolios remain more neutral at the short end of the yield curve and overweight the long end in anticipation of continued curve flattening. SEI's strategies are overweight credit and agency mortgaged-back securities. In the high-yield space, our portfolios favor duration short of the benchmark.

Glossary

Cyclical sectors, industries or stocks are those whose performance is closely tied to the economic environment and business cycle. Cyclical sectors tend to benefit when the economy is expanding.

Duration is a measure of a security's price sensitivity to changes in interest rates. Specifically, duration measures the potential change in value of a bond that would result from a 1% change in interest rates. The shorter the duration of a bond, the less its price will potentially change as interest rates go up or down; conversely, the longer the duration of a bond, the more its price will potentially change.

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

Spread is the additional yield, usually expressed in basis points (one basis point is 0.01%), that an index or security offers relative to a comparable duration index or security (the latter is often a risk-free credit, such as sovereign government debt). A spread sector generally includes non-government sectors in which investors demand additional yield above government bonds for assumed increased risk.

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

Value refers to the tendency for relatively cheap assets to outperform relatively expensive assets.

Index Definitions

Bloomberg Barclays U.S. Aggregate Bond Index: The Bloomberg Barclays US Aggregate Bond Index is a 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.

China Shenzhen Index: The Shenzhen Composite Index is a market-cap weighted index that tracks the stock performance of all A shares and B shares (B shares are denominated in renminbi but traded in Hong Kong dollars) traded on the Shenzhen Stock Exchange. It is not adjusted for free float (shares available for public trading).

ISM Manufacturing Index: The ISM Manufacturing Index is based on surveys of more than 300 manufacturing firms by the Institute for Supply Management (ISM). The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries. A composite diffusion index monitors conditions in national manufacturing and is based on the data from these surveys.

MSCI China Index: The MSCI China Index captures large- and mid-cap representation across China H and B shares, Red chips, P chips, and foreign listings (such as ADRs). With 151 constituents, the Index covers about 85% of this China equity universe.

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

MSCI USA Index: The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the U.S. market. With 632 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in the U.S.

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

OECD Leading Economic Index: The index is designed to provide early signals of turning points in business cycles showing fluctuation of the economic activity around its long term potential level.

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.

Shanghai Stock Exchange Composite Index: The Shanghai Stock Exchange Composite Index is an unmanaged index that consists of all stocks that are traded on the Shanghai Stock Exchange.

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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.

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