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QUARTERLY MARKET COMMENTARY | Q3 2018

Hardened Postures Threaten Trade Relationships

Quarterly Snapshot

- The U.S. escalated its trade fight with China, while the North American Free Trade Agreement's (NAFTA) successor came into focus as the U.S. reached agreements with Mexico and Canada. Elsewhere, U.K. Prime Minister Theresa May declared that Brexit negotiations had reached an impasse.
- U.S. equities gained throughout the third quarter, while U.K. equity shares fell somewhat and European shares were slightly positive during the period. Government bond yields climbed across all maturities in the U.S., U.K. and EU.
- Maintaining exposure to risk assets may feel uncomfortable at this point—yet we believe it's important for investors with long time horizons to know that mistiming entries and exits into and out of equities can be quite costly.

Economic Backdrop

The U.S. escalated its trade fight with China late in the third quarter, enacting tariffs of 10% on $200 billion of Chinese products and promising to increase them to 25% in the New Year. President Donald Trump pointed to an additional prospective $267 billion in Chinese products that could also be subjected to tariffs if China were to retaliate—which it did, although on a significantly smaller scale (applying tariffs of 5% to 10% on $60 billion of U.S. exports to China). China asked the World Trade Organization (WTO) to impose sanctions on the U.S. twice during the quarter in response to disputes dating back several years. NAFTA's successor came into focus during the third quarter—first when the U.S. and Mexico came to agreement in August, and then when the U.S. and Canada finally ironed out their differences in the last few hours of September. Now called the United States-Mexico-Canada Agreement (USMCA), the revised deal is expected to strengthen its predecessor's "made in North America" provisions and improve labor standards. The U.S. is projected to offer Canada and Mexico relief from automobile-related trade barriers as a result of the new agreement, although aluminum and steel tariffs will remain.

U.K. Prime Minister Theresa May declared that Brexit negotiations had reached an impasse by the second half of September. EU leaders rejected her so-called Chequers plan, which had become a rallying point for cabinet officials (besides those who resigned early in the third quarter in protest of the plan's "softness"). May reminded EU officials that she believes no deal is better than a bad deal; her government began planning for the growing probability of a "hard Brexit." She used an interview on the sidelines of a September United Nations summit to assert her ambition that, in the post-Brexit world, Britain will offer the lowest corporate taxes in the G-20 (the international forum for economic decision-making that comprises 19 countries plus the EU). U.K. and U.S. market regulators made a shared appeal to the EU in early September for deference in letting other countries monitor their qualifications for access to EU securities markets. The EU and Japan finalized a major trade deal early in the third quarter that eliminated most tariffs between the two trading partners; the U.S.-EU trade relationship warmed in July following a meeting between European Commission President Jean-Claude Juncker and President Trump.

Key Measures: Q3 2018

Equity		
Dow Jones Industrial Average	**9.63%**	↑
S&P 500 Index	**7.71%**	↑
NASDAQ Composite Index	**7.41%**	↑
MSCI ACWI Index (Net)	**4.28%**	↑
Bond		
Bloomberg Barclays Global Aggregate Index	**-0.92%**	↓
Volatility		
Chicago Board Options Exchange Volatility Index PRIOR QUARTER: **16.09**	**12.12**	↓
Oil		
WTI Cushing crude oil prices PRIOR QUARTER: **$74.15**	**$73.25**	↓
Currencies		
Sterling vs. U.S. dollar	**$1.30**	↓
Euro vs. U.S. dollar	**$1.16**	↓
U.S. dollar vs. yen	**¥113.59**	↑

Sources: Bloomberg, FactSet, Lipper

The EU, Russia and China established a vehicle that can accommodate international banking with Iran. The system was developed to circumvent sanctions against Iran that were applied by the U.S. after the Trump administration withdrew from a multi-lateral nuclear accord. (The International Atomic Energy Agency has since said that Iran still complies with its responsibilities to the accord). Elsewhere, India took over a major infrastructure finance company at the end of the third quarter on the belief that it was at risk of failing and potentially destabilizing the financial system. The financing agreement between Argentina (South America's second-largest economy) and the International Monetary Fund increased to $57 billion late in the third quarter. Argentina and Turkey both faced currency collapses during the third quarter when their respective domestic economic situations deteriorated amid less accommodative global financial conditions.

U.S. equities climbed throughout the third quarter, while Japanese shares finished higher after a late-quarter rally. U.K. equity shares fell a bit during the three-month period after partially recovering from an early September selloff; European shares were slightly positive after doing the same. Brazilian equities were positive for the third quarter, albeit below their early-August highs. Government bond yields climbed across all maturities in the U.S., U.K. and EU.

The Federal Open Market Committee increased the federal-funds rate at the end of the third quarter, as anticipated, for the third time in 2018. Expectations remained for one additional rate hike in December. The Bank of England's Monetary Policy Committee increased the bank rate by 0.25% in early August and then abstained from further action at its mid-September meeting. Governor Mark Carney announced that he will delay his departure from the central bank until January 2020 in order to offer a measure of stability during the Brexit transition period. Neither the European Central Bank (ECB) nor the Bank of Japan announced new policy actions following their separate late-July and mid-September monetary-policy meetings.

U.S. services growth moderated through July and August, albeit at healthy levels, and slowed further in preliminary reports for September. Non-manufacturing sector activity fell in July from red-hot levels and reaccelerated in August. Manufacturing growth jumped to start the quarter, retreated in August, and recovered during September. Consumer confidence climbed to its highest level in 18 years during the third quarter; jobless claims continued to trend downward, attaining new 50-year lows along the way. Overall economic growth increased by an annualized 4.2% in the second quarter, up from 2.2% in the first quarter.

U.K. services sector growth slowed notably to start the quarter, but partially recovered in August. Manufacturing activity recovered in September after bordering on slow-growth territory in August. The claimant-count unemployment rate edged up to 2.6% in August. The unemployment rate for the May-to-July period held firm at 4%, and average year-over-year earnings growth increased from 2.4% to 2.6% for the same three months.

Overall economic growth maintained a pace of 0.4% for the second quarter, yet slid to 1.2% year over year from the first quarter.

European manufacturing growth leveled off to start the third quarter, yet dipped at the end of the period; services growth slowed to start before partially recovering in September. The eurozone unemployment rate continued to edge lower through the quarter, finishing August at 8.1%. The final reading of broad second-quarter economic growth registered 0.4% (in line with the first quarter) and 2.1% year over year (down from 2.5% in the prior quarter).

Portfolio Review

U.S. equities continued to set the pace for stock markets around the globe during the third quarter. Large caps outperformed small caps, and growth beat value. Our large-cap strategy was held back by an underweight to information technology and an overweight to energy, while our small-cap strategy performed well on the merits of stock selection in information technology and consumer discretionary. International developed-market stocks had a strong quarter, but lagged U.S. equities. Our strategy struggled with weak performance from the consumer discretionary, industrials and energy sectors. From a regional perspective, our strategy's failure to keep pace with strong performance in Japan detracted from performance. Emerging-market stocks ended the third quarter on a negative note, delivering losses in contrast to the positive performance generated by U.S. and international developed-market stocks. Our strategy was challenged by poor selection in materials amid concerns about slowing Chinese economic growth, overall positioning in technology, and selection in banking.

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Major Index Performance in Q3 2018 (Percent Return)

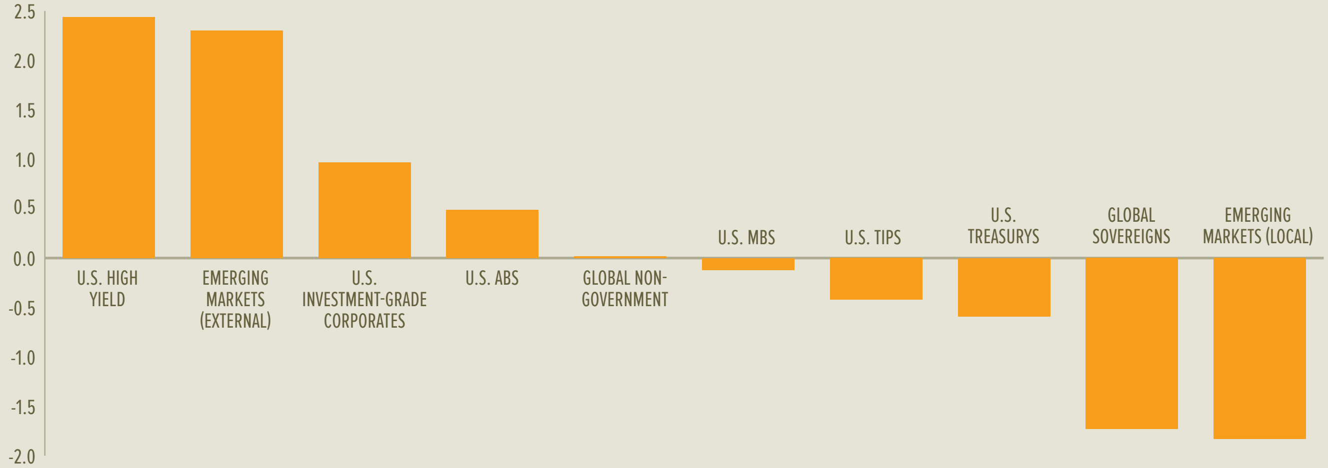
Sources: FactSet, Lipper

U.S. investment-grade non-government fixed-income sectors outperformed comparable Treasurys during the third quarter. Our core fixed-income strategy underperformed as duration began the quarter modestly long, which detracted as yields rose. A slight overweight to corporate credit contributed given its outperformance of Treasurys, as did an allocation to non-agency mortgage-backed securities (MBS) and a modest overweight to agency MBS. Asset-backed securities (ABS) and commercial MBS (CMBS) also outperformed, benefitting our overweights, although our higher-quality bias within CMBS held back relative performance. Underweights to taxable municipals and U.S. dollar-denominated sovereign bonds detracted as both outperformed. The U.S. high-yield market had a strong third quarter, and our strategy performed in line with the benchmark. Selection within the energy sector served as our top contributor, and was also beneficial in technology and electronics. An allocation to Puerto Rico helped support relative performance as well. The largest detractor during the quarter was our allocation to bank loans, which underperformed the high-yield market. Selection within basic industry and overall positioning within healthcare also detracted. Within emerging markets, a volatile third quarter saw sovereign-debt markets rally in July, plummet in August, and recover in September. Our strategy was challenged given exposure to emerging-market currencies and positioning within Turkey and Argentina; while the hardest-hit areas for the quarter overall, they partially offset their underperformance during September's recovery.

Manager Positioning and Opportunities

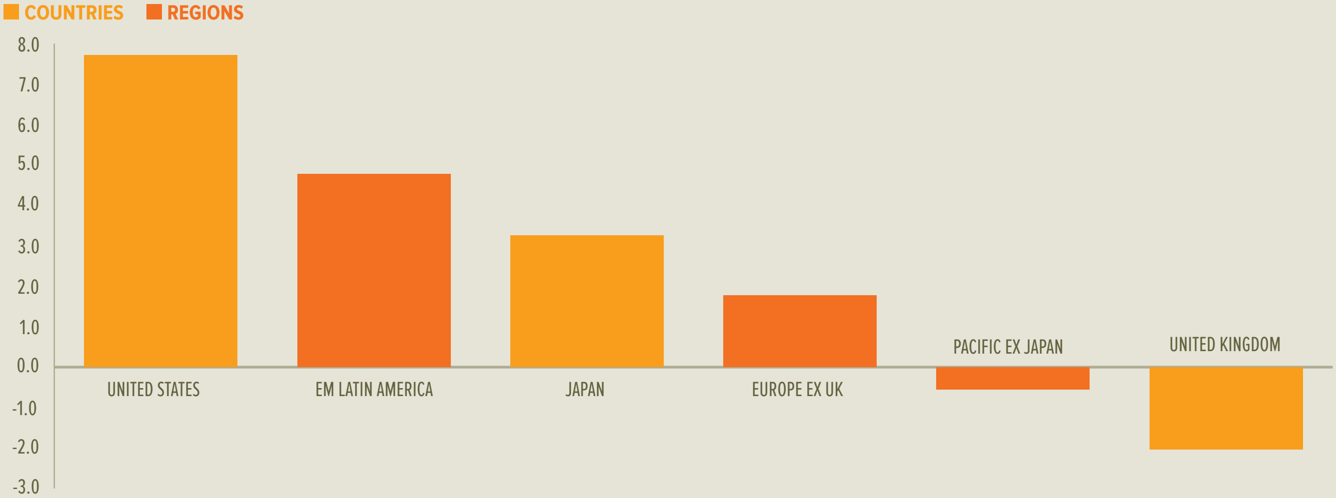
The economic environment and earnings trends are favorable for U.S. stocks, but valuations are noticeably above their long-term averages. Markets may experience volatility due to high valuations, rising interest rates and potential geopolitical events. Within large caps, we remained tilted toward value to capture the long-term premium from owning

Fixed-Income Performance in Q3 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 Q3 2018 (Percent Return)



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

undervalued securities, and we're underweight the largest-capitalization stocks given the availability of selection opportunities further down the capitalization spectrum. Within small caps, we slightly reduced our sensitivity to market volatility and believe an emphasis on fundamentals and valuations should support active management. We added to our value holdings and trimmed our momentum exposure, remaining positioned to favor value, followed by momentum and then stability. Our international developed-market equity strategy retained an overweight to technology given the growth of the internet and digital services around the globe. We also retained a slight overweight to industrials—specifically commercial and professional services and transportation stocks, which benefit from global growth—yet trimmed holdings in capital goods and transportation given growing uncertainty about global trade. We also reduced consumer discretionary holdings concentrated in the auto sector. We added to healthcare holdings and decreased an underweight to financials, but remained significantly underweight traditional defensive sectors (consumer staples, telecommunications and utilities). Emerging-market positioning continued to favor the long-term structural adoption of internet usage and reliance on technology hardware. We also remained overweight industrials, but moved into a neutral weight within consumer discretionary after trimming exposure to Hong Kong and Korean holdings. We used the third-quarter pullback as an opportunity to add to energy stocks in India and Russia, where valuations do not trade with earnings power. We continued to favor private banks in India (due to their competitive position) as well as Greek banks (due to their massive upside potential), but underweighted Chinese banks on quality concerns. Exposures to Turkey and Argentina were trimmed during the quarter.

Our core fixed-income strategy's duration posture remained long, albeit slightly shorter than at the beginning of the third quarter, and our yield-curve-flattening bias was reduced. We selectively added to a modest corporate-sector overweight and retained a preference for banking, as the late-quarter heavy-issuance calendar got underway. ABS and CMBS overweights remained given their competitive risk-adjusted yields, although we've been selective in avoiding lower-quality issues. An allocation to non-agency MBS and overweight to agency MBS were maintained given still-supportive housing-market fundamentals. Our high-yield strategy retained a bank-loan allocation as well as sizeable overweights to leisure and media. Energy was our largest underweight, followed by financial services and banking. Within emerging markets, our strategy was neutral weight to local-currency debt and slightly underweight hard currency in favor of an allocation to corporate debt. Our top country overweights were to Argentina, Mexico and Egypt, while our most significant underweights were to Romania, Philippines and Malaysia.

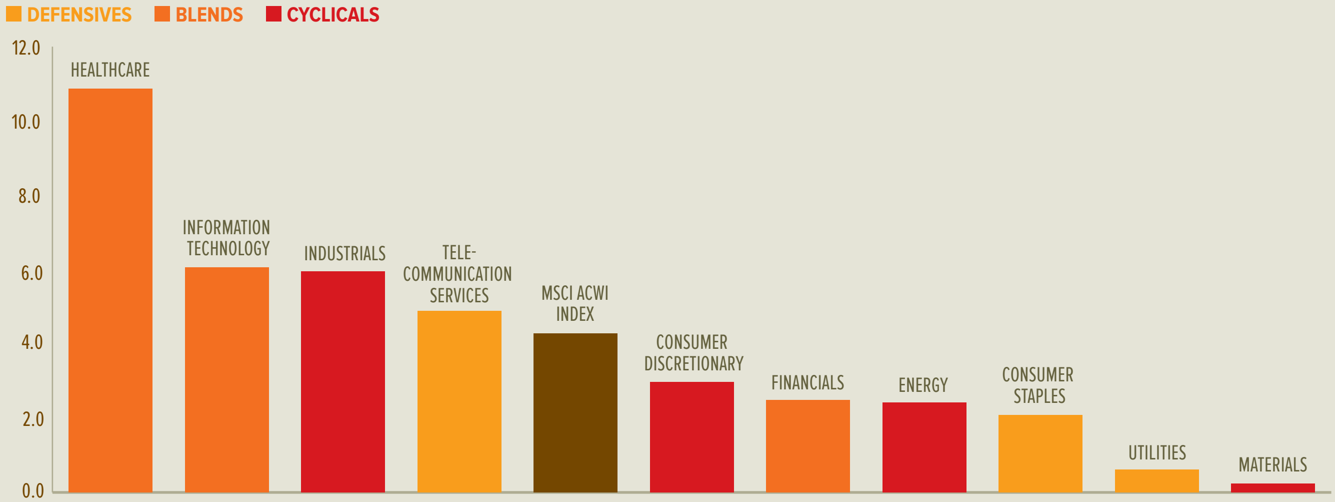
Our View

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 has global implications. China and the U.S. together accounted for 42% of world nominal gross domestic product (GDP) last year.

China's currency has fallen sharply not only against the dollar but also against a broader basket of currencies. The weaker currency partially offsets the impact from tariffs imposed by the U.S. The competitiveness of Chinese exporters against other countries has also improved as a result of this year's devaluation.

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.

Global Equity Sector Performance in Q3 2018 (Percent Return)



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

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. Investors appear to have reached the same conclusion. While the U.S. flirts with new all-time highs, the Shenzhen Stock Exchange Composite Index fell into bear territory in the third quarter, declining more than 25% from the peak recorded in late January. Remember that China makes up more than 31% of the MSCI Emerging Markets Index.

We still think it's premature to turn negative on the near-term outlook given today's mosaic of economic fundamentals.

Although the near-term view is fraught with uncertainty, we continue to believe in diversifying portfolios with emerging-market exposure. The alpha opportunities (that is, the ability to achieve returns in excess of benchmarks) also are much greater, given the economic and political idiosyncrasies inherent in the asset class. The price-to-earnings ratio for emerging-market stocks is running at about a 30% discount to that of the U.S. stock market, near attractive relative-valuation levels last seen in early 2016.

As the trade war with China heats up, the Trump administration has turned more conciliatory toward other countries with which it has picked fights. Broad agreement has been reached with USMCA, which replaces NAFTA. The threat of tariffs on European and Japanese autos and auto parts has also 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.

In Europe, there are business-as-usual problems: sluggish economic growth, still-high unemployment and the never-ending disagreements over how expansive monetary policy should be. Europe also faces trade tensions of its own. The U.K. is far more dependent on the EU as an export market than the other way around. A "hard" Brexit will 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 nowadays, 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 Organisation for Economic Co-operation and Development's Leading Economic Indicators show that the U.K. has experienced the most dramatic deterioration of the world's major developed economies.

As if the future departure of the EU's second-largest member isn't bad enough, Italian yields have risen sharply higher this year as the Lega/Five-Star coalition pushes to make good on some of its campaign promises. Italy is the third-largest eurozone economy, and has the fourth-largest debt-to-GDP ratio in the world. 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).

A complicating factor for Italy and other highly-indebted countries is the tapering of asset purchases by the ECB. Since the program's inception, the ECB's purchases of Italian bonds equate to 53% of the country's cumulative deficit. Italy will be losing a large price- and risk-insensitive buyer of its bonds at an inopportune time. The ECB is set to finish its taper at the end of the year.

It's been quite a run for U.S. equities for much of the past nine years. The relative performance of the U.S. against other developed- (MSCI World ex USA Index) and developing-country (MSCI Emerging Markets Index) stock markets has been stellar, whether the yardstick is in U.S. dollar or local-currency terms.

The fundamental outlook remains favorable for U.S. equities despite trade-war concerns and the rising trend in interest rates. Tax cuts, deregulation and strong revenue growth have provided an ideal backdrop for U.S. equities to appreciate, but performance could be constrained if earnings estimates fade in light of increasing tariffs on tradable goods. The multiple on those estimated earnings also could fall if interest rates climb at a faster-than-expected pace. That said, we still think it's premature to turn negative on the near-term outlook given today's mosaic of economic fundamentals. In our view, risks to the U.S. stock market are evenly balanced.

The multi-year persistence of high corporate profit margins is unusual. 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.

Besides rising trade tensions with China, we see the Federal Reserve (Fed) as another, more traditional, major potential threat to the U.S. equity bull market. 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. We agree with the Fed's view that the funds rate is still below the so-called neutral rate of interest. Additional rate increases appear appropriate, as long as the Fed doesn't keep hiking beyond the neutral rate—a level that has historically seen the stock market run into real trouble.

One can argue about whether the valuations embedded in the U.S. equity market are 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 strategies certainly tilt in the direction of more value-oriented companies and industries in our actively-managed portfolios.

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 should know that mistiming entries and exits into and out of equities can be costly. Today, mistiming an exit is the greater concern.

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 (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.

MSCI World ex USA Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity-market performance of developed markets, excluding the U.S.

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.

Shenzhen Stock Exchange Composite Index tracks performance of A and B share stocks on China's Shenzhen Stock Exchange.

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)

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