Monthly Market Commentary

Oil and Dollar Rise, Brexit Looms

May 2016

SEI New ways. New answers.®

- Conditions were generally favorable in May in U.S. dollar terms, with a late-month equity-market rally, continued recovery in energy prices, and mixed fixed-income market performance.
- Renewed U.S. dollar strength helped drive fixed-income returns, which were led by U.S. high-yield bonds and U.S. dollar-hedged or dollar-denominated global securities.
- We remain bullish, and the fundamentals of U.S. risk assets seem better than most. Defensive equity sectors still look expensive, as do government fixed-income securities.

Economic Backdrop

Investors were mostly treated to hospitable conditions in May: equity markets began on a soft note but rallied late in the month, and energy prices continued to recover — even amid renewed dollar strength (relative to the euro and yen) — ahead of an Organization of the Petroleum Exporting Countries meeting in early June, although fixed-income market performance was mixed.

Short-term U.S. Treasury yields increased (yields and prices move inversely) as the Federal Reserve (Fed) expressed a desire to increase benchmark rates if and when conditions warranted (although a disappointing U.S. jobs report dampened expectations for a move over the next few months). The European Central Bank's 2 June monetary policy announcement offered a reminder that two stimulus measures introduced in March — corporate-bond purchases and targeted long-term repo operations (bank loans) — would begin in June. The Bank of England's Monetary Policy Committee decided unanimously to maintain its current stance as the European Union (EU) referendum loomed, while a late May meeting in Japan of leaders from Group of Seven (G7) major developed-economy nations produced a communique that also highlighted concerns over potential Brexit fallout.

The U.S. unemployment rate slid to 4.7% in May alongside a declining pool of labor market participants, as job growth dropped to its slowest pace since 2010. Consumer spending jumped in April with the greatest gain in almost seven years, due in large part to automobile and services sales. Income also rose significantly in April, possibly contributing to an improvement in consumer sentiment during May to its best reading in almost a year. Manufacturing activity expanded slowly in May after industrial production advanced in April at the highest rate since late 2014. Consumer prices increased in April by the most in more than three years due to a recent recovery in oil prices. Revised first-quarter economic growth showed an improved expansion of 0.8% attributable to an increase in residential investment and exports.

A welcomed jump in U.K. services sector activity during May put space between April's survey, which had reported the slowest growth in more than three years. Manufacturing clawed its way slightly out of contraction territory in May, while construction growth decelerated. May year-over-year sales volumes improved following a significant drop in April, although expectations for June were lackluster given the Brexit specter. Retail-level sales were strong in April, however, offsetting a prior slump and jumping ahead year over year. Inflation was mixed according to the latest data for April, with consumer price growth remaining subdued despite firming at the producer level, particularly within input prices (which were still sharply negative year over year). The labor market stabilized in March and April, with unemployment declining slightly and wages posting modest improvement. Economic growth expanded by 0.4% in the first quarter, driven primarily by household consumption.

European consumer confidence had its largest month-over-month improvement in more than two years during May, and business sentiment was strong regarding the retail and construction sectors. Manufacturing remained in slow-growth mode during May, while services activity improved on a recent dip in an otherwise sustained expansion. Retail sales were flat in April after a sharp drop in the previous month, with a notable decline in German activity holding back overall sales. Consumer prices were marginally lower on the year ending in May, due primarily to lower energy prices; the core measure (which excludes energy and other items like food) was edged higher, but remained far short of the ECB's target. The unemployment rate remained at 10.2% in April, masking improvement in France and Spain, while Germany was unchanged and Italy lost ground; youth unemployment also moderated. First-quarter economic growth was modestly slower than expected, at 0.5%, and 1.5% year over year. Flagging activity among goods producers was primarily responsible for the downward revision.

Market Impact

The global fixed-income market declined in May, as measured by the Barclays Global Aggregate Index, amid U.S. dollar strength that put downward pressure on non-U.S. dollar denominated securities. U.S. high-yield bonds remained the strongest performing fixed-income segment, followed by U.S. dollar-hedged (which seeks to reduce U.S. dollar-related volatility) global sovereign securities. Dollar-hedged global non-government debt was also positive, while U.S. mortgage- (MBS) and asset-backed securities (ABS) were only marginally so. Local-currency denominated emerging-market debt had the deepest losses due in significant part to dollar strength, as its foreign-currency-denominated (external) counterpart was just modestly negative. Unhedged global sovereign and non-government debt declined, as did U.S. Treasury Inflation-Protected Securities. U.S. investment-grade corporate fixed income had minimal losses.

Global equity markets, as reflected by the MSCI AC World Index (Net), advanced modestly during May. Greece was the top-performing country, followed by the Philippines, Ireland and Belgium. India, the U.S. and Taiwan had strong returns, as did Denmark and the Netherlands. Brazil and Turkey delivered the poorest performances, while Colombia and South Africa were also deeply negative. Global sector performance was led by information technology, healthcare was a distant second, and consumer staples had a small gain. Materials had the steepest decline, followed by energy. Industrials, utilities, telecommunications and consumer discretionary all had losses, while financials were only slightly negative.

Index Data

- The Dow Jones Industrial Average Index advanced by 0.49%.
- The S&P 500 Index increased by 1.80%.
- The NASDAQ Composite Index rose by 3.83%.
- The MSCI AC World Index (Net), used to gauge global equity performance, advanced by 0.13%.
- The Barclays Global Aggregate Index, which represents global bond markets, declined by 1.34%.
- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index that is also known as the “fear index”, decreased in the month as a whole, moving from 15.70 to 14.19.
- WTI Cushing crude oil prices, a key indicator of movements in the oil market, moved from $45.92 a barrel at the end of April to $49.10 on the last day in May.
- The U.S. dollar strengthened relative to the euro and yen, and was unchanged against sterling. The U.S. dollar ended May at $1.46 versus sterling, $1.11 against the euro, and at 110.9 yen.

Portfolio Review

U.S. equities performed well in May, with smaller companies outpacing larger ones and growth-oriented stocks reclaiming the lead from value. Large-cap performance benefitted from sector positioning, specifically an overweight to the top-performing technology sector. An emphasis on value and underweight to stability contributed, while an underweight to momentum detracted; value-oriented stock selection was also challenged. Small-cap performance was disadvantaged by selection within healthcare and industrials, although positioning in technology and financials contributed; an overweight to energy hurt while an underweight in discretionary helped. Overseas, developed-market equity performance was modestly positive; regionally, we benefitted in the U.K. by avoiding materials companies, selection in financials was positive, while consumer staples was an area of weakness. European performance was overall positive, driven primarily by selection in Germany, Belgium, Denmark and Spain. Japan was neutral, while an underweight to Australia contributed. Canadian exposure detracted. Emerging-market performance was comparably strong in a negative absolute-return environment, thanks largely to positioning in Asia: Korean holdings fared relatively well, an underweight to Malaysia was beneficial given a sharp drop in the ringgit (Malaysia’s currency), and selection in Taiwanese technology companies helped offset the drag from an underweight there. Russian holdings performed well, an overweight to Turkey detracted amid political upheaval, and an underweight to South Africa was beneficial as its financials came under scrutiny. Latin America performed poorly after a strong April, although exposure in Argentina helped defy the selling pressure elsewhere.

Core fixed income continued to perform well as a majority of non-government sectors generated positive excess returns. A sudden change in sentiment on the possibility of a Fed rate hike in June caused short-term U.S. Treasury yields to rise in a greater magnitude than intermediate-term yields, while long-term yields declined benefitting both a modestly shorter duration posture and a yield-curve flattening bias. An emphasis on corporate credit detracted slightly, although financials outperformed within the corporate sector, benefitting an overweight there. ABS and commercial MBS outperformed amid the continued search for higher yields, an overweight to non-agency MBS continued to return to favor, while an underweight to agencies detracted as they outperformed. Within high yield, an allocation to structured credit and selection within media, healthcare and leisure contributed, while an underweight to and selection within energy, an overweight to and selection within retail, and selection within services detracted. Performance was challenged within emerging markets, as local-currency debt succumbed to negative currency effects following a multi-month recovery, while external debt was largely flat. Argentina was the most significant contributor after returning to the global debt market with an oversubscribed issuance. Off-benchmark exposure to Slovenia also contributed as improving fundamentals have begun to clear the way to a conclusion of budget oversight by the EU. An overweight to Mexican local debt was the greatest detractor as the peso was among the worst-performing currencies. Currency depreciation also hurt South Africa as a potential credit-rating downgrade emerged.

Manager Positioning and Opportunities

We are constructive on the outlook for the U.S. equities as earnings are expected to grow enough to support an advance, but we expect the volatility to remain given that we are in the mature stages of a bull market. We continue to increase our risk-premium exposure through deeper-value due attractive risk/reward profiles and cheap valuations. The recent move in commodity prices and improvement in high-yield spreads are necessary preconditions for value and cyclicals to outperform stability and defensives. We have also added to sustainable growth at the expense of momentum growth, which looks expensive. Internationally, we have retained pro-cyclical developed-market positioning with sensitivity to valuations and an overweight to small caps. We maintained an underweight to consumer staples given elevated valuations, save for select food retailers that have suffered amid food-price deflation, which is poised to stabilize. We have used weakness in energy and materials to increase positions, albeit while retaining a slight underweight to materials. Information technology remains the most significant overweight, while financials remains the largest underweight; even so, we have found opportunities in select insurance companies that have demonstrated a degree of immunity to the negative interest rate environment. Positioning has also remained relatively consistent within emerging markets, with a continued overweight to technology, particularly Chinese hardware suppliers and social media names, as well as in Taiwan based on attractive valuations. A consumer discretionary overweight was reduced slightly, pushing the sector’s exposure to an underweight in India. Consumer staples and healthcare remain slight overweights, with the former achieved partly via exposure to Russian retail stocks with solid earnings growth and cheap valuations. Industrials swung from a small overweight to a small underweight on reduced exposures to China and Indonesia. A large underweight to financials remains, driven primarily by an underweight to Chinese banking stocks, along with smaller underweights to telecommunications and utilities.

Core fixed income’s duration posture remains slightly short to neutral with a yield curve flattening bias. We are slightly overweight corporate credit, with a small overweight to the industrial sector on a risk basis, and our largest overweight in banking. Bank spreads were essentially unchanged in May after lagging during the first quarter, but still remain wider that they were at yearend. Bank capital positions are much stronger than they were pre-crisis, which puts them on firmer footing today, so we will likely continue to add exposure selectively. Within high yield, we remain overweight media and leisure, primarily gaming, as well as technology and electronics. Media is an asset-rich sector with strong cash-flow generation and reasonable amounts of leverage, and there is conviction that some gaming credits are undervalued and offer strong total-return potential. Furthermore, both sectors are generally less sensitive to changes in macroeconomic conditions. We maintain underweights to the energy sector, as well as the metals/mining subsector (excluding steel) within basic industry. A defensive posture via bank loan and cash allocations remains. Within emerging markets, we remain underweight external debt, with our largest positions in Mexico, Argentina, Indonesia, Brazil, Hungary, Colombia and Ukraine. Our largest external underweights are to the Philippines, Lebanon, Russia, Poland, China and Malaysia. We retained an overweight to corporates in conjunction with the external debt underweight. An overweight to local-currency debt remains, with the largest overweights in Russia, Colombia, Mexico, Poland and Indonesia. Our largest local bond underweights are in Hungary, Peru, Turkey, Singapore, Taiwan and China. In currency terms, our largest overweights are in Russia, Colombia, Mexico, and Poland while our most significant underweights are in Hungary, Turkey, Singapore and Taiwan.

Our View

One of our bedrock macroeconomic assumptions has been that the world will avoid a generalized recession, managing to continue muddling through. We believe a synchronized global recession that drags most countries into negative gross domestic product territory remains a low-probability event, and if our forecast holds, the rally in risk assets should be able to build on itself. Certainly, there are good reasons to view the glass as half empty. Monetary policy appears to be losing effectiveness in Europe and Japan. Combined with an increasingly febrile political environment in the U.S. and other countries, as well as widespread sovereign and corporate over-indebtedness, it is easy to see why market strategists are still a cautious lot. But we think too much emphasis has been placed on the weaknesses of the global economy, while the brighter spots have been mostly ignored. Most major countries remain in an expansion phase despite sustaining a growth scare over the past year. The main areas of concern can be found in emerging markets, especially in commodity-producing countries.

On a sector basis, it's obvious energy and materials have been the primary drag, but it's a mistake to assume that a contraction in these industries will lead to a downturn in advanced, service-based economies. Even in light of recent oil-price strength, the spike in energy sector layoffs has been nearly offset by the improving trend in the construction trades as housing activity comes back to life.

The bottom line: We continue to believe that global economic growth will grind its way higher, led by the advanced and commodity-consuming emerging economies (including China and India). Although China's debt is a concern, the bulk is owed by state-owned enterprises to quasi-state-owned banks. Only a small fraction is held by foreign investors. The central government's debt ratio is rather low, and households are not highly leveraged either.

Another bedrock assumption of ours has been the conviction that central-bank monetary policy will remain highly expansionary on a global basis. Even in the U.S., where economic growth and inflation appear more entrenched than in most other countries, it is unlikely that interest rates will be pushed higher in an aggressive manner. A more interesting question is whether central banks have reached the end of their policy effectiveness. This issue has come to the forefront in 2016 as the BOJ, and then the ECB, implemented radical policy prescriptions only to see markets react negatively. In both Europe and Japan, government bond yields now are negative out to 7 and 10 years, respectively. If there is an overvalued asset in the world it is a negative-yielding government bond. Corporate bonds, too, have begun edging into negative-yield territory following an announcement by the ECB of its intention to serve as a buyer in that market starting in June.

And yet the yen and the euro have gained against the greenback on a year-over-year basis. This resiliency runs counter to our own expectation that a widening interest-rate differential between the U.S. and those two countries would keep the greenback strong. If the dollar's weakness continues, it would have far-reaching consequences for global assets. It would, for example, be positive for commodities as well as emerging-market debt and equity.

It's hard to make a fundamental case for this dramatic turn in the fortunes of emerging-market equities. Earnings per share (EPS) for the constituents of the MSCI Emerging Markets Index have collapsed over the last two years in U.S. dollar terms, a performance that correlates closely with the bear market in commodity prices. We need to see stronger global economic growth, improved trade flows and additional supply discipline from commodity producers. The sharp improvement in investor sentiment might be enough to keep the rally going in the short run, but it's not enough for a sustained bull market.

At this point, we see better prospects for a durable earnings revival in the U.S. than elsewhere. The stalling of the dollar's appreciation against other currencies in the past year suggests that U.S.–based multinational corporations and import-sensitive industries should see some relief from negative currency translations and declining import prices. Given the economic and political uncertainties, markets will remain difficult to navigate. We lean in a bullish direction, mainly because we are confident that the world economy will exhibit modest growth and that central banks around the world will do "whatever it takes" to coax their economies to grow and push inflation in an upward direction. Defensive equity sectors still look expensive, as do government fixed-income securities. We like U.S. risk assets because the fundamentals seem better than most, although political dysfunction is becoming an increasing worry. Meanwhile, the sharp recovery in emerging-market debt and equity and high-yield securities underscores the fact that beaten-down areas can come roaring back with little advance warning. Under these circumstances, diversification seems a better strategy than concentrated positions as trends shift back and forth in almost random fashion.

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

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the Funds or any stock in particular, nor should it be construed as a recommendation to purchase or sell a security, including futures contracts.

There are risks involved with investing, including loss of principal. Current and future portfolio holdings are subject to risks as well. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Narrowly focused investments and smaller companies typically exhibit higher volatility. Bonds and bond funds will decrease in value as interest rates rise. High-yield bonds involve greater risks of default or downgrade and are more volatile than investment-grade securities, due to the speculative nature of their investments. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Diversification may not protect against market risk. There is no assurance the objectives discussed will be met. Past performance does not guarantee future results Index returns are for illustrative purposes only and do not represent actual portfolio performance. Index returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index.

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