Economic Outlook

Fourth Quarter 2016

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The Triumph of Trump

By: James R. Solloway, CFA, Managing Director and Senior Portfolio Manager

- Change is coming in various aspects of U.S. policy — economic, social and diplomatic.
- Investors need to be prepared for a more volatile ride as 2017 unfolds.
- We maintain our long-held view that equities generally will do well versus fixed-income securities, that the U.S. will hold its own against other markets and that yields will increase over time as inflation makes a mild comeback.

I hold it that a little rebellion now and then is a good thing, and as necessary in the political world as storms in the physical. - **Thomas Jefferson, third U.S. president (1801 to 1809)**

There are decades where nothing happens; and there are weeks where decades happen. - **Vladimir Ilyich Lenin, first head of the Soviet state (1917 to 1924)**

You have to think anyway, so why not think big? - **Donald J. Trump, U.S. president-elect**

As Donald J. Trump prepares to become the forty-fifth president of the United States at noon on January 20, the world holds its breath. There is so much about him that is unconventional that it is hard to say where he wants to take, or can take, the country in four years' time. All we can say is that change is coming to various aspects of U.S. policy — economic, social and diplomatic. Dramatic change is made more probable by virtue of Republican majorities in the House and Senate as well as Republican dominance in state legislatures and governorships. In addition, many achievements of President Barack Obama's administration were the result of executive actions that potentially can be reversed at the stroke of a pen. The new president will also have the opportunity to appoint a Supreme Court justice — and perhaps one or two more over the course of his tenure — which would leave conservative justices to hold the majority in the highest court in the land for a long time to come. Changes in such areas as healthcare policy and immigration will have economic impact too.

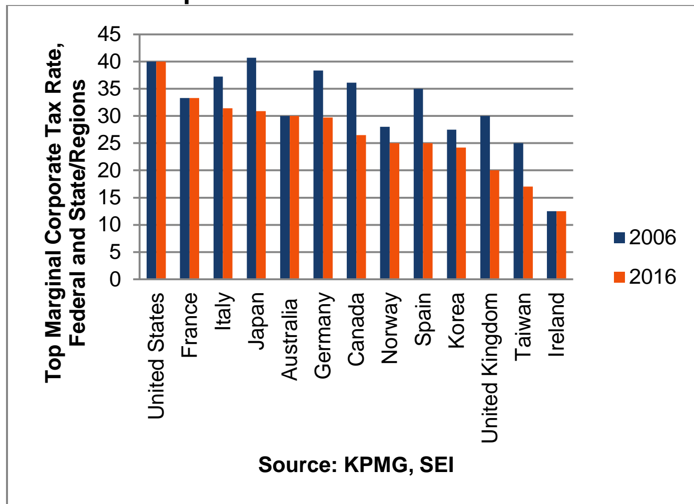
In any event, we expect to see a great deal of legislative activity in the months ahead — the equivalent of Lenin's "weeks where decades happen." The gridlock that froze Washington in its tracks legislatively over the past six years is over. Within the next few months, we expect to see a variety of bills, executive actions and departmental decisions that will aim to break down disincentives that have impeded hiring, bank lending, new-business formation and investment.

Markets, of course, have already reacted. Large-cap stocks, as measured by the Russell 1000 Index, climbed by more than 5% since the election and 12% for the year as of December 31, 2016. The Russell 2000 Index, which tracks small-cap stocks, has leapt 14% since November 8, and is up a stunning 21% for the year. Meanwhile, the U.S. bond market had its worst monthly performance in 12 years during November, with the Bloomberg Barclays U.S. Aggregate Bond Index down 2.7%. For the year, the Index recorded just a 2% rise on a total-return basis. Investors are betting that the shake-up in Washington will lead to higher growth and profitability — as well as higher inflation. We suspect this knee-jerk reaction in the immediate aftermath of the election is, more or less, the right one. Nonetheless, since there are still more questions than answers regarding the details of policies, timelines, implementations and impact, investors need to be prepared for a more volatile ride as 2017 unfolds.

So what do we think we know about future economic policy? First, corporate marginal tax rates are set to decline. The incoming Trump administration has suggested a 15% top statutory rate versus the current 35%. That would take the U.S. from the highest statutory rate among developed countries to almost the lowest. As Exhibit 1 illustrates, the representative top marginal tax rate on U.S. businesses (federal plus an average estimate for state/local tax regimes) hasn't changed over the past 10 years. Most countries, by contrast, have lowered their top corporate tax rate in an effort to stimulate economic growth. Japan, for example, has lowered its tax rate from over 40% in 2006 to almost 30% 10 years later. In the

U.K., the top corporate rate has been slashed from 30% in 2006 to 20%; the government announced further cuts, reducing rates to 19%, effective April 2017, and to 17% by April 2020.

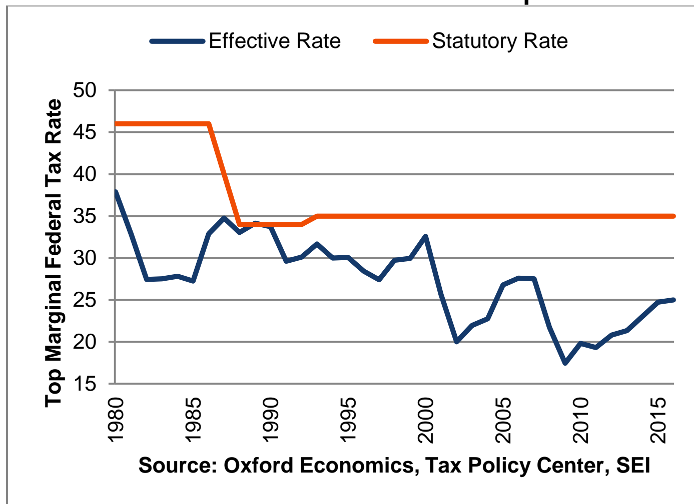
Exhibit 1: Deep in the Heart of Taxes



Source: KPMG, SEI

Exhibit 2 highlights the yawning differential between the federal statutory rate (reflecting the tax rate set by law) and the effective rate (which reflects what corporations actually pay). Currently, corporations pay an effective tax rate of about 25%; domestically oriented, service-producing companies pay close to the top rate of 35%.

Exhibit 2: It Will be Hard to Close this Gap



Source: Oxford Economics, Tax Policy Center, SEI

Of course, slashing the federal corporate tax rate to 15% would require the elimination of most deductions, allowances and industry-specific tax preferences — to not only limit the revenue loss on the government's budget, but also to level the playing field among different types of economic activity. Limits on the deductibility of interest expense, for example, would be a major change that would affect debt/equity funding decisions.

A 15% rate may be hard to achieve given corporate-tax lobbyists' power to maintain beneficial tax loopholes for their clients. Still, a tax cut to 20% and reforming the tax code to tax earnings on a territorial basis instead of globally (as is done in other countries) would be a marked improvement over the current corporate-tax regime. Instead of imposing a value-added or national sales tax like other countries, the Republican plan calls for a cash-flow approach that eliminates taxes on exports but imposes them on imports. This measure is running into a buzz-saw of opposition from various business groups (such as retailers and oil refiners) that would be hurt by higher prices on imports. Opposition aside, the intent is to close the gap between the effective tax rate and the statutory rate for the first time since the major tax reforms enacted in 1986 by the Reagan administration. We expect a cut in the statutory tax rate, although it may not fall as far as currently envisioned.

In addition to the reduction in corporate tax rates, the incoming Trump administration plans to offer a one-time tax of 10% (versus up to 35%) to repatriate cash currently held abroad. It is estimated that U.S. corporations hold some $2.5 trillion in foreign jurisdictions; Microsoft, GE, Apple, Pfizer and IBM together account for roughly $450 billion of that cash hoard. Although not all of that money will be brought back into the U.S., even half of it returning would represent a substantial inflow.

The last time Washington declared a "tax holiday" on repatriated funds between October 2004 and October 2006, 843 corporations brought back a total of $362 billion, of which $31 billion was subject to a tax rate of 5.25%, according to the Internal Revenue Service. A study conducted by the National Bureau of Economic Research found that companies used 60% to 92% of the proceeds to bump up shareholder payouts via dividend increases and share buybacks. Looking at the S&P 500 Index, dividends per share grew at a 12% annual rate between 2004 and 2006. Aided by stock repurchases, earnings per share accelerated to 23% in 2004 and grew an additional 15% in 2005 and 14% in 2006.

Exhibit 3 examines the Federal Reserve's (Fed) Flow of Funds data as it pertains to the cash flows of non-financial corporations. To gain an even better appreciation of the overall impact of repatriation, we look at the sum of (1) net dividends paid to investors and (2) the net equity repurchased by non-financial corporations as a percentage of the total market value of equities (the higher the ratio, the greater the amount of money flowing to investors for each dollar of stock-market value). As of the third quarter, this ratio amounted to 5.7%, slightly above the 5% average for the past 30 years.

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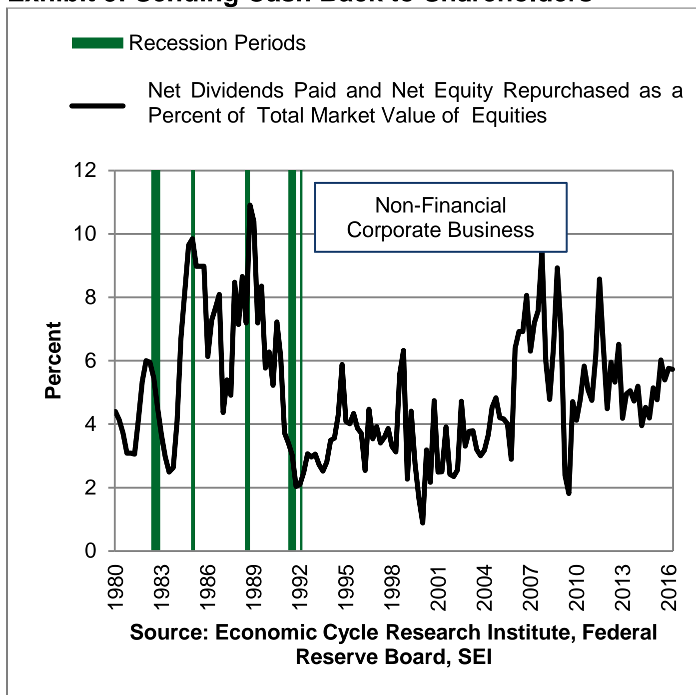
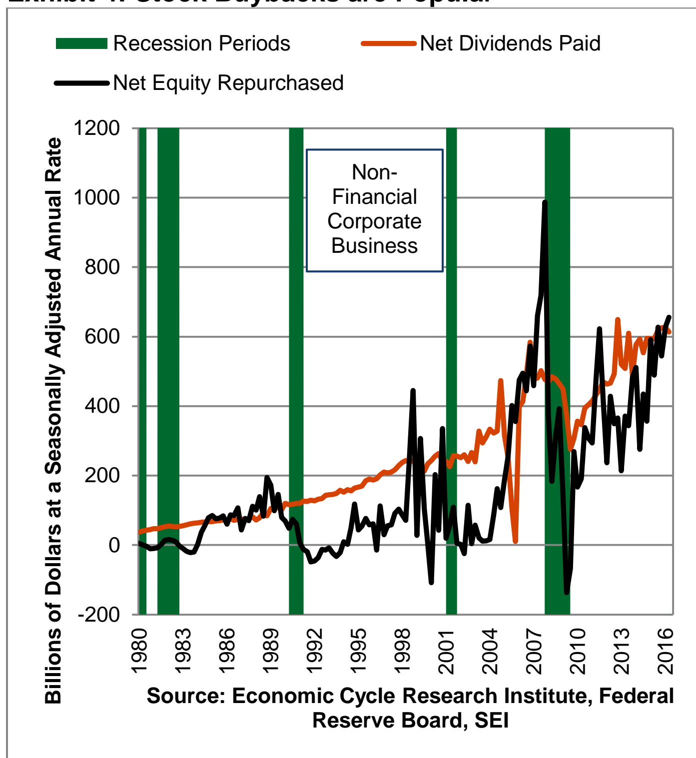
Exhibit 3: Sending Cash Back to Shareholders



Source: Economic Cycle Research Institute, Federal Reserve Board, SEI

Between 1983 and 1984, this ratio rose rapidly as stock buybacks became an important use of corporate cash, as seen in Exhibit 4.

Exhibit 4: Stock Buybacks are Popular



Source: Economic Cycle Research Institute, Federal Reserve Board, SEI

A second burst of stock buybacks occurred at the start of the 1998-to-1999 technology bubble. During the 2004-to-2006 repatriation tax holiday, stock repurchases took off in an unprecedented fashion. Net equity repurchases totaled $93 billion in 2004. They climbed to $300 billion in 2005 and to almost $500 billion in 2006, reaching a peak in 2007 of nearly $1 trillion. Of course, not all of this retirement of equity in the last cycle was the result of lower tax rates and the repatriation tax holiday. Corporate cash flow surged as the global economy grew. Companies especially benefited from the boom in China and other emerging markets, as well as from the expansion of outsourcing and the extension/deepening of supply chains. The 2007-to-2009 global financial crisis, by contrast, witnessed a precipitous slide in both dividends and stock buybacks to 2004 levels. This downturn proved temporary. Today, we see little evidence that stock buybacks or dividend payments are going out of style; although limits on interest deductions may change that calculus for some companies.

We've focused on corporate tax cuts because there is a strong consensus within Washington to relieve the burdens facing small businesses and to unlock the cash pile held overseas by the nation's largest multinational corporations. Individual tax rates also will be lowered, resulting in a far-greater impact on federal government revenues. Hence, we expect a bigger fight over how to achieve this without busting the budget. Treasury Secretary-elect Steven Mnuchin has indicated that he wants to give middle-income earners a tax break, but no net reduction of tax liabilities to higher-income groups. This will be a difficult trick to pull off if the top federal tax rate is to be cut from 39.6% to 33%, given President-elect Trump's previously expressed desire to also cut capital-gains and estate taxes. Reducing and/or eliminating deductions and allowances will not be enough to keep the reforms revenue-neutral at the highest income levels. But we expect that individual rate cuts and a certain amount of tax simplification are on the horizon. In the near-term, this will raise the deficit and provide a net fiscal boost to the economy.

In addition to tax reform, deregulation will be given a high priority. Healthcare, energy and banking appear to be the main focus of early Trump-administration efforts. President-elect Trump's cabinet picks clearly indicate that the administration intends to undo much of the Obama legacy. The over-arching goals in these root-and-branch deregulation efforts will be to reduce the cost of doing business and encourage more hiring, especially among small businesses that traditionally have been the primary job creators. Exhibit 5 illustrates the current small-business pressure points, as surveyed by the National Federation of Independent Business.

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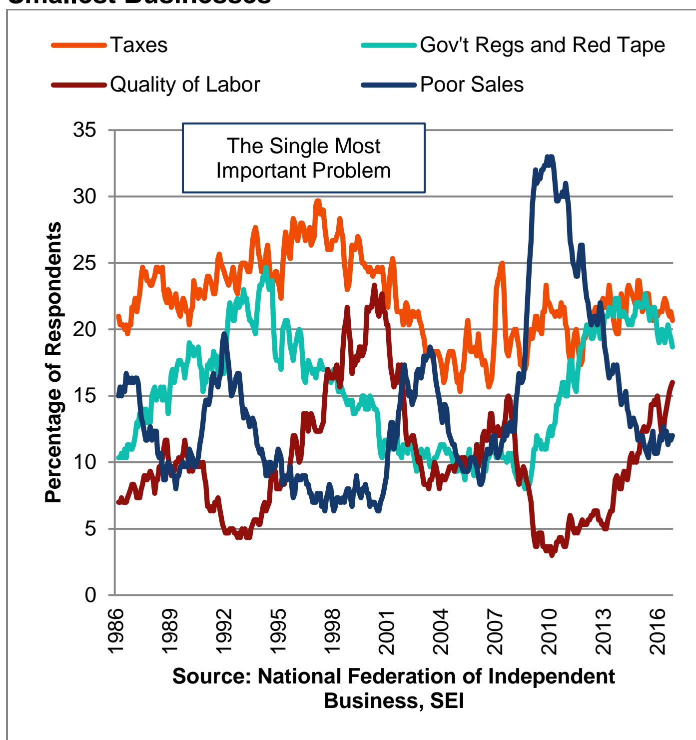
Exhibit 5: The Biggest Problems for the Smallest Businesses



Source: National Federation of Independent Business, SEI

Taxes and regulations top the list of problems facing small businesses, similar to the early-1990s experience. Interestingly, the quality of labor is quickly becoming a greater concern too, reaching a level not seen in two decades. This is typically a late-cycle phenomenon that occurs as the economy nears full employment.

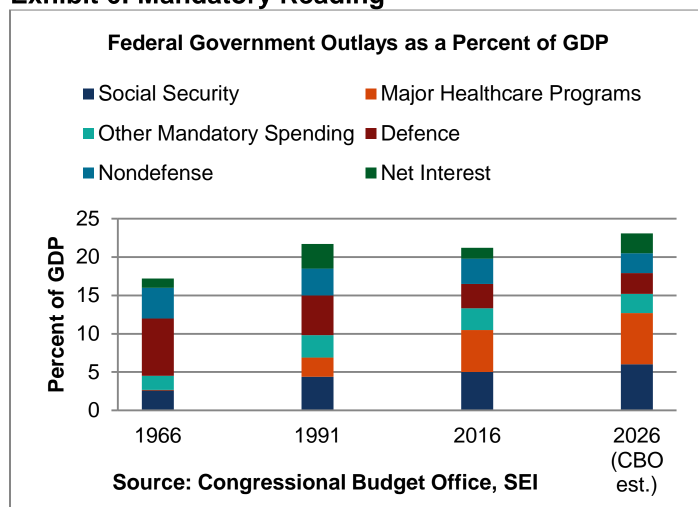
Harking back to the early years of the Reagan administration, defense spending was boosted to a significant degree, adding to the fiscal stimulus provided by major tax cuts. The incoming Trump administration appears ready to pursue a similar strategy, combining tax cuts with infrastructure expenditures. The ultimate size of the program, as well as its timing, remains unclear. A nice round figure of $1 trillion over 10 years is commonly cited by President-elect Trump. In our opinion, this is one aspect of Trumponomics that can be eased into over a period of several years, given the fact that labor markets have already tightened. Besides, Congress passed a five-year $305-billion transportation bill in December 2015; so a pile of spending is already in the works. Finally, as President Obama himself has admitted, shovel-ready projects aren't so shovel-ready in reality. Making infrastructure repairs through private-public partnerships may have its merits, but the devil will be in the details.

In all, the election of Donald Trump will almost certainly result in more fiscal stimulus than if Hillary Clinton had become president while facing an ideologically hostile Congress. We think that over the next two or three years, the federal budget deficit could expand by more than 2% to 2.5% of gross domestic product (GDP) on a cyclically adjusted basis as a result of tax cuts and additional spending. Fingers will be crossed that deregulation and the lifting of various cost burdens will spark a pick-up in economic growth and tax revenues that mitigate the pressure on the government's finances.

Longer-term, however, demographic pressures on mandatory spending will be the primary budgetary challenge — as it has been for several decades. Exhibit 6 shows how spending on Social Security, healthcare programs (such as Medicare and Medicaid) and other mandatory income-support programs have progressed inexorably higher.

Discretionary defense and non-defense programs can only be squeezed so much to prevent overall federal spending as a percentage of the economy from pushing higher. If anything, geopolitical tensions could lead to a major step-up in defense expenditures in the years ahead. And, of course, net interest payments have been held artificially low as a result of the Fed's near-zero interest-rate policy and the impact of global quantitative easing. As interest rates normalize, interest payments will accelerate on the existing $20 trillion government debt. Even if the incoming president enjoys an extended honeymoon in 2017, fiscal hawks will start squawking soon enough — perhaps leading to the same kind of drama and histrionics (for example, debt-ceiling debacles, threatened government shutdowns and fiscal cliffs) that marred the Obama years.

Exhibit 6: Mandatory Reading



Source: Congressional Budget Office, SEI

The Donald's Darker Side

While equity markets have celebrated the change in political direction, Trumponomics is not without problematic policies — particularly the president-elect's focus on throwing up impediments to trade. Admittedly, it is hard to separate the bombast and bluster of a consummate showman from positions and viewpoints that are more deeply held. We believe that elections have consequences, however, and one of the more important

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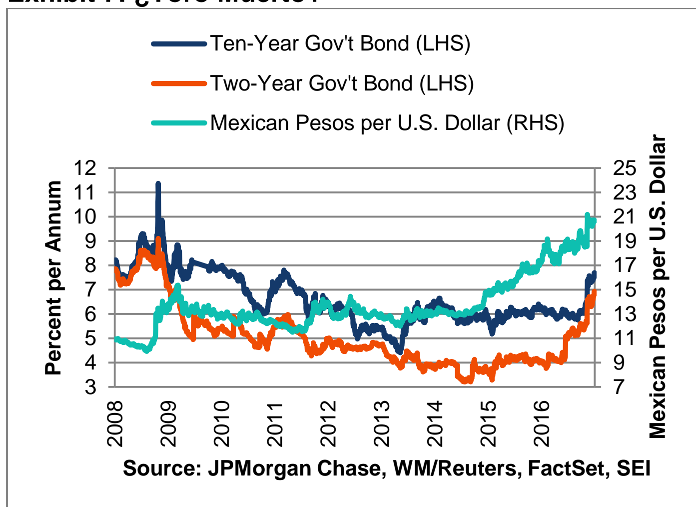
ones will be the change in how the U.S. interacts with the rest of the world.

President-elect Trump continues to focus most of his attention on two trade issues — the North American Free Trade Agreement (NAFTA) and bilateral trade with China. With respect to NAFTA, we expect pragmatism to prevail. The agreement has been in place for 22 years, tying the economic well-being of the U.S. to two of its largest trading partners (Canada and Mexico). A recent article in the *Wall Street Journal* examined the impact that trade with Mexico has on the Texas economy — a state, by the way, that provided 36 of the president-elect's 304 electoral votes. According to the article, more than 380,000 jobs in the state depend on trade with Mexico; and the value of Texas exports to that country in 2015 amounted to $92.5 billion — almost 40% of total U.S. exports to Mexico. (As an aside: Michigan, which gave 16 electoral votes to Trump, accounts for the third-highest export value shipped to Mexico.)

If President-elect Trump jettisons NAFTA, the disruption to trade will be extensive — running counter to the new administration's pledge to bring back manufacturing jobs to the country. We suspect, however, that the agreement simply will be reviewed and modestly adjusted. The Mexican government is already on record saying that it is in favor of "modernizing" NAFTA. In any event, investors have reacted sharply to Mr. Trump's fiery rhetoric. The Mexican peso has weakened considerably over the past two years (Exhibit 7), partially on concerns about Mr. Trump's intentions on trade and immigration.

Exhibit 7: ¿Toro Muerto?



Source: JPMorgan Chase, WM/Reuters, FactSet, SEI

The Mexican bond market has also weakened since last May, around the time Trump wrapped up the nomination. Still, we think the worries of a unilateral repeal of NAFTA by the U.S. and the imposition of stiff tariffs on Mexican exports are way overdone.

On the other hand, we fear trade relations with China could get worse before they get better. The new administration seems intent on pressing its case that China does not play by the rules when it comes to the protection of intellectual property and equal access to its markets. We think the odds are moving in favor of the Treasury Department designating China as a currency manipulator. What that designation means in practice remains to be seen, but the president has substantial autonomy to impose temporary anti-dumping duties on a trading partner's products and industries. While we may not see a 45% across-the-board tariff on Chinese imports, a rifle-shot approach in areas like steel and aluminum products could be employed early on. We doubt the Chinese government will just sit still and take it. A tit-for-tat confrontation between the U.S. and China over trade and other issues, such as cyber-security and China's aggressive island-building in the South China Sea, would be a matter of deep concern for investors.

President-elect Trump has also expressed willingness to tear up the newly minted Trans-Pacific Partnership (TPP) agreement. It may be true that TPP helps the smaller signatories more than the U.S. (precisely why Trump railed against it), but the demise of the TPP potentially damages our relations with trading partners around the Pacific Rim. It also gives China an opening to extend its economic and political influence in the area.

To repeat, there is no certainty when it comes to the tactics President-elect Trump will employ to attain a "better deal" on trade. That noted, the odds of a confrontation with China seem uncomfortably high to us. The accelerating decline in the renminbi against the dollar to its lowest level in more than eight years will not help matters (Exhibit 8). Nor will the incoming Trump administration's cavalier willingness to shake up political protocol by treating (or is it tweeting?) Taiwan as an independent, sovereign nation. Diplomatic relations often depend upon a willingness to turn a blind eye to the facts on the ground. Thus far, President-elect Trump has not shown much in the way of diplomatic nuance.

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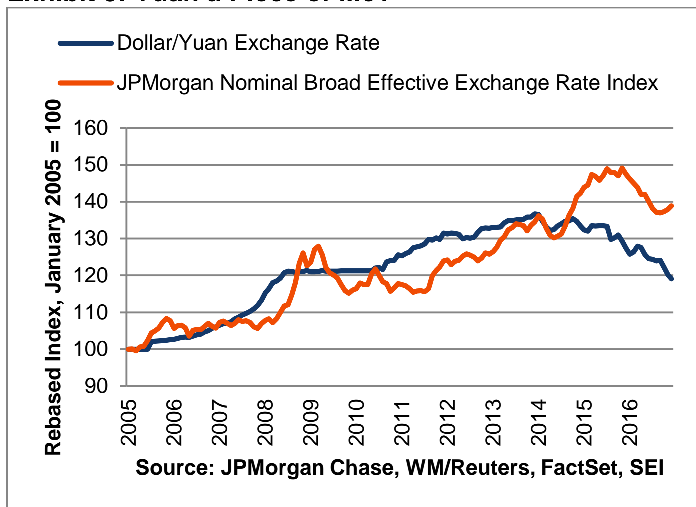
Exhibit 8: Yuan a Piece of Me?

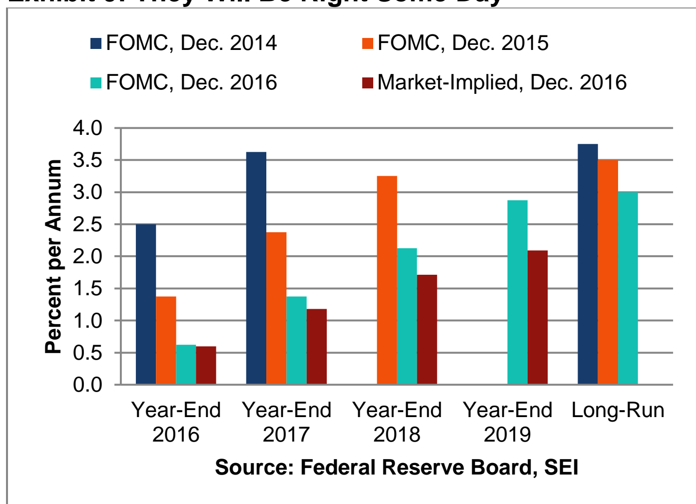


Source: JPMorgan Chase, WM/Reuters, FactSet, SEI

The Fed Adds Fuel to the Dollar's Fire

To no one's surprise, the Fed lifted its federal-funds target by one-quarter of a percentage point (25 basis points) in December to a range of 0.50% to 0.75%. What surprised the markets was a bump in the number of rate increases projected by the members of the Federal Open Market Committee (FOMC) for 2017, from two to three. The median FOMC forecast of the funds rate by the end of 2017 is now 1.4%. This action should be kept in perspective. As Exhibit 9 illustrates, the Fed governors and regional presidents have been woefully poor prognosticators of their own future actions. A year ago, FOMC members thought they would raise the funds rate to 1.4% by the end of 2016, and to 2.4% by the end of 2017. Two years ago, the comparable respective median forecasts for 2016 and 2017 were 2.5% and 3.6%.

Exhibit 9: They Will Be Right Some Day



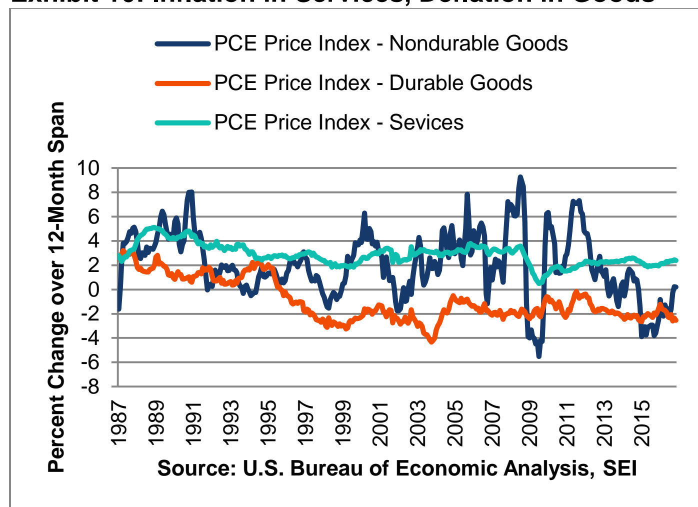
Source: Federal Reserve Board, SEI

In its September 2016 meeting, the FOMC threw in the towel and announced dramatically lower interest-rate projections. Although recent optimism about U.S. growth prospects and the impact of Trumponomics may have influenced policymakers' thinking, we can still say that they expect interest rates to stay lower for longer. At 3%, the Fed's latest long-run equilibrium forecast for the federal-funds rate remains meaningfully below what it projected even a year ago.

The gap between the FOMC's median projections and the rate implied by the futures market (the burgundy columns in Exhibit 9) still indicates a certain amount of investor skepticism that rates will move up as briskly as the central bank is projecting in the longer term. This difference of opinion is fairly small for 2017. We think that two or three rate increases in the year ahead is a reasonable guess.

Bond yields, of course, have soared in the aftermath of Trump's election victory, reflecting a pronounced rise in inflation expectations. Inflation in the U.S. has been percolating beneath the surface for a while, hidden by a combination of dollar strength and energy-price weakness. Using the Fed's preferred inflation yardstick — the personal consumption expenditures price index (PCE Price Index) — inflation in services has accelerated in recent months (Exhibit 10). Deflation remains a feature of goods prices, however, especially for durable items. The dollar's strength is an important factor in pressuring durable-goods prices lower, and the greenback's recent strength suggests this will continue. Innovation that lowers the price of computing power over time is another long-lived factor. Lowering costs through outsourcing to developing countries is a third and perhaps most critical factor in the view of the new administration. President-elect Trump would likely point at the chart in Exhibit 10 and blame NAFTA because the deflation trend began to take hold in 1995, the year NAFTA took effect.

Exhibit 10: Inflation in Services, Deflation in Goods



Source: U.S. Bureau of Economic Analysis, SEI

The most volatile part of the personal consumption expenditures price index is non-durables. The gyrations in this component are driven primarily by price changes in food and energy. Oil prices, of course, have popped higher following the recent Organization of Petroleum Exporting

Countries (OPEC) production agreement. While we are skeptical that production discipline can hold for more than a few months, year-over-year gains should be substantial and feed into the overall price index in a big way during the first half of 2017. This is already baked into investors' calculations, and the reaction in bond yields should be limited.

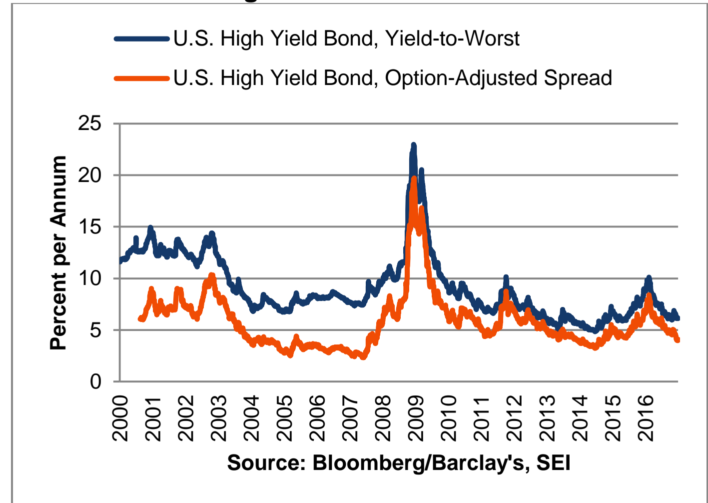
In all, we think the benchmark Treasury bond will avoid breaching the 3% mark next year. Underlying inflation is not likely to pick up a big head of steam, even if tax cuts and infrastructure spending provide a bigger-than-expected boost to economic growth. We do think risks are skewed to the upside. The FOMC forecasts that the economy will grow only 2.1% next year, while we think real GDP growth could be closer to 3%. The policymakers seem to be assuming that fiscal policy effects will be minimal, even if tax cuts are enacted quickly. If the FOMC forecast also assumes that real GDP growth will be constrained as the economy approaches full employment, one can question whether inflation can indeed be contained at or below 2% this year and next.

So how are SEI's portfolios reacting to changes in the political and economic outlook? To a large extent, positioning was already consistent with a pro-growth, value-oriented, rising-interest-rate environment. Our equity portfolios have overweight exposures to banks, energy and materials. They are selling technology shares. However, given the massive rotation into value stocks and out of stability and growth over the past several months, they are now beginning to trim exposure to value and are adding back to the latter areas. Defensive stocks are beginning to look attractive once again, trading at a two-point earnings-multiple discount to the market.
Small-cap stocks, as previously mentioned, have skyrocketed since the election, with deeper cyclical and higher-volatility names leading the way. Investor hopes for changes to the Dodd-Frank legislation have led to a massive rally in small regional-bank stocks. This hurt portfolio performance relative to benchmarks, since our small-cap portfolios were underweight the group. In general, small-cap positioning continues to reflect an underweight to momentum and stability and an overweight to stocks that exhibit deeper-value and sustainable-growth characteristics.

On the fixed-income side, we believe a 3% 10-year Treasury bond represents the upper bounds of the trading range over the next year. U.S. interest rates still appear attractive versus yields in other major developed countries, so there should be a limit to how high they go in the near-term — even if growth and inflation in the U.S. surprises somewhat to the upside. Overall, core portfolios are neutral-to-slightly short duration[1] against their benchmarks. They favor BBB rated issues over AAA rated issues and employ curve-flattener strategies (for example, long the 30-year bond, short the two-year).

In the high-yield market, option-adjusted spreads versus Treasurys have tightened to their narrowest levels since 2014 on the same economic optimism that has propelled equity prices (Exhibit 11).

Exhibit 11: Sending Out an OAS*



* Option-adjusted spreads estimate the difference in yield between a security or collection of securities and comparable Treasurys after removing the effects of any special features, such as provisions that allow an issuer to call a security before maturity.

The jump in energy prices has also relieved pressure on highly indebted oil and gas producers. The overall default rate within the U.S. high-yield universe in November 2016 was 5.57%, above the long-term average of 4.5% since 1980. The high-yield market appears priced for a default rate closer to 4% by this time next year. Positioning has been steady: slightly short benchmark duration, yielding 75 basis points more than the benchmark, and credit quality (single B) in line with the benchmark yardstick. Our high-yield portfolios are overweight the healthcare industry, so changes made to the Affordable Care Act by the new administration and Congress will be worth watching. The portfolios are still underweight energy and basic materials issuers, but are adding exposure to those areas.

[1] 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.

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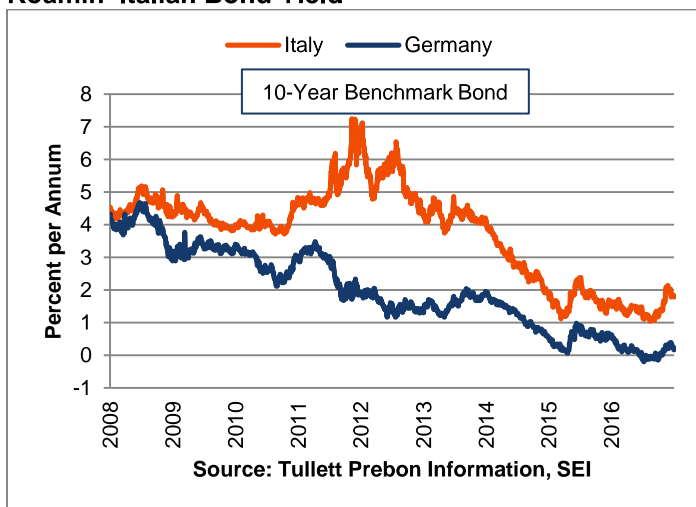
European Vexation

While the world anxiously waits to see which direction the incoming Trump administration will take the U.S., the winds of political change are also blowing through Europe. Italy's referendum on December 4 already led to the resignation of Prime Minister Matteo Renzi. The caretaker government led by Paolo Gentiloni, formerly the foreign minister in the Renzi administration, promises continuity until the next election (which will most likely be held in February 2018, but could come sooner). As we discussed in last quarter's *Economic Outlook*, Italy remains dogged by an uncompetitive, stagnating economy and a banking system plagued with non-performing loans and inadequate capital. The country's oldest and third-largest bank, Monte Dei Paschi, is now being bailed out by the government.

Politically, Italy seems ripe for an upending of the status quo. Thus, it should not be surprising that the establishment parties are working to change the rules of the game to make sure the populist Five Star Movement party (founded by political activist Beppe Grillo) fails to gain the seats necessary to form a government when the next election comes. Investors seem to be taking a wait-and-see approach to this drama. As Exhibit 12 illustrates, yields on Italian 10-year bonds have eased since the referendum, but remain near levels last seen during the Greek debt crisis of 2015. Still, at less than 2%, yields on the country's 10-year government bonds do not seem to be pricing in much risk.

Exhibit 12: The Rise and Fall Of the Roamin' Italian Bond Yield



The Italian referendum kicked off a year of important political events in the eurozone. General elections will be held in the Netherlands, France and Germany. Of these three, we judge the French presidential elections to have the greatest importance for investors. Not only is France the eurozone's second largest economy, it is also the country in which the election outcome could create the most impactful and far-reaching changes. The first round will be held April 23, with the final round on May 7. Current President François Hollande has taken himself out of the running due to his low popularity. It looks likely that the Socialists vying to take his place will split the vote in the first round, resulting in a final-round match-up between François Fillon, the center-right Republican candidate, and Marine Le Pen, the leader of the ultra-nationalist National Front.

The structure of French presidential elections usually prevents an extreme party from gaining power, even if that party manages to progress to the second round of voting. In 2002, for example, Jacque Chirac and Jean-Marie Le Pen (Marine's father) advanced into the final round with only 20% and 17%, respectively, of a widely divided vote. Voters on both the left and right then coalesced around Chirac, handing him 82% of the vote.

A similar outcome is expected by political analysts in this election cycle. Polls suggest that the National Front's support is capped at about 30% of the electorate, so a blocking coalition of the left and the right-centrist parties should easily hand the election to Fillon. But there's a catch: Fillon is himself a rather unconventional politician, promising to be France's version of Margaret Thatcher. His platform includes scrapping the 35-hour workweek, increasing the retirement age to 65 from 63, eliminating more than 500,000 public-sector jobs and cutting corporate taxes and the social obligations of small- and medium-sized businesses. To say the least, this seems to run against the grain of French voters' economic preferences. If he were elected and tried to follow through on these promises, he and the country probably would be forced to endure a tumultuous period of massive industrial actions, as Thatcher and the U.K. did 35 years ago.

We have no doubt that Fillon's proposed restructuring of the French economy will be anathema to the Socialists and other voters on the left. Will they hold their noses and vote for him anyway? Will they stay home? Or will they vote for Le Pen, whose stances on immigrants and Islam they view as morally repugnant? Some of her economic positions — raising the minimum wage, lowering the pensionable age to 60, introducing barriers to trade — will appeal to a wide segment of the population. Her anti-immigrant, anti-euro views may well keep her out of the Élysée Palace when all is said and done; but in this period of anti-establishment ferment, we hesitate to rule it out. And so, French voters are facing a binary decision: they either take a lurch toward Thatcherite conservatism that promises to undo a portion of the welfare state, or they take a gamble on economic nationalism that could lead to the unraveling of the euro-currency framework. While the political oddsmakers currently favor Fillon by a large margin, those polls could tighten as the election nears. On the other hand, a Fillon victory has the potential to be positive for the French economy and financial assets. Stay tuned.

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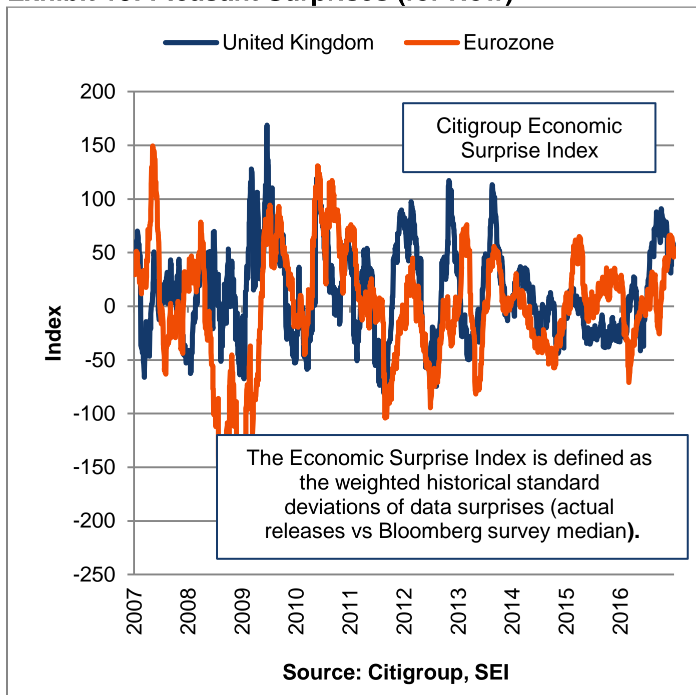
While political considerations remain a source of angst in Europe, economic growth actually has surprised observers to the upside lately. Citigroup's Economic Surprise Index (which measures the extent of surprise caused by data releases, based on the reaction of the currency market) has improved sharply in recent months. Both the eurozone and the U.K. have come out with some upbeat numbers compared to expectations since September and July, respectively (Exhibit 13).

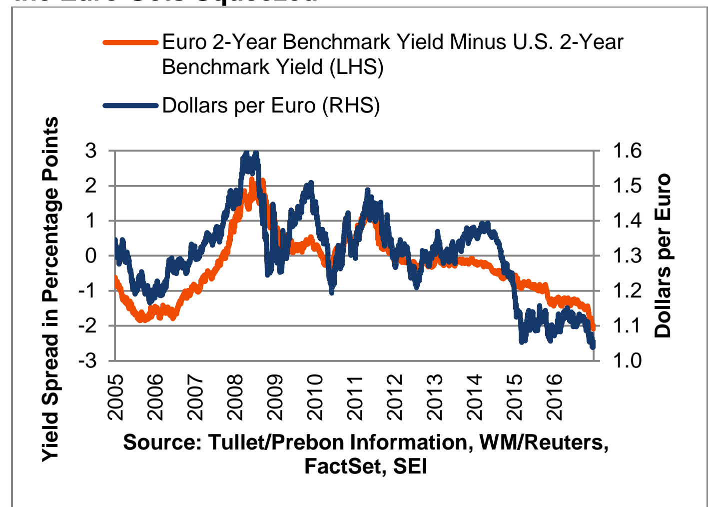
Exhibit 13: Pleasant Surprises (for Now)



This improvement simply may reflect some easing of the immediate concerns surrounding Brexit. The U.K. government continues to release various trial balloons ahead of formal negotiations with the European Union (EU). Although sometimes confusing and contradictory, the latest line offered up by the May government seems to be emphasizing a "soft-Brexit" approach that will be less disruptive to trading relations between the U.K. and the EU. It's still early in the negotiations, however; in fact, they don't formally begin until Article 50 is invoked at the end of March. Investor attitudes could again turn cautionary in the months ahead. Besides, it takes two to tango: the other 27 member countries of the EU may want to make an example of the U.K., showing how costly it can be for a country to exit. We expect a tough period of negotiation that could lead to yet another period of investor uncertainty and angst.

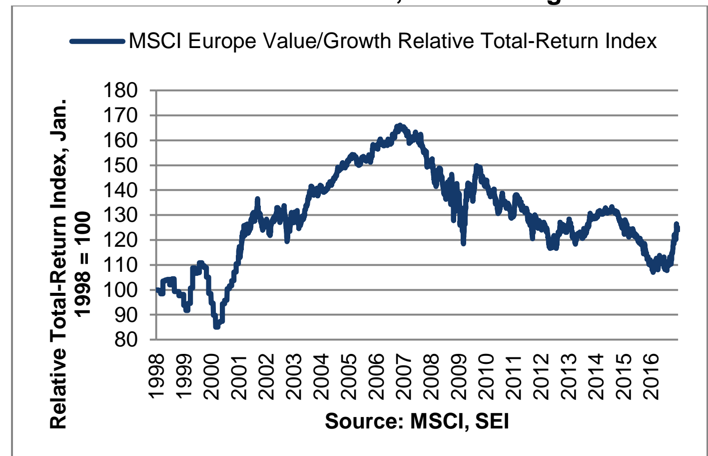
In the meantime, the better economic numbers offer a welcome respite. This optimism is reinforced by the renewed weakness in the euro against the dollar. Trump's election and the ramping-up of expectations for growth and inflation in the U.S. have catalyzed an appreciation of the dollar against most currencies. The European Central Bank's decision to extend asset purchases through the end of 2017 (albeit at a somewhat reduced pace) emphasizes the divergent paths of monetary policy in Europe versus the U.S. As Exhibit 14 highlights, interest-rate differentials have widened meaningfully between U.S. Treasury and eurozone (German) benchmark two-year notes. That spread recently exceeded two percentage points. This should keep the pressure on the euro in the months ahead, since capital flows where it is expected to be treated best.

Exhibit 14: As Spreads Widen, the Euro Gets Squeezed



Our European-equity portfolios, like our U.S. portfolios, emphasize value and have a pro-cyclical stance. They see more potential upside, since value investing in Europe has been out of favor for a long time. As Exhibit 15 shows, even after the exceptional rise in value versus growth since the summer, the MSCI Europe Value/Growth relative-strength line is still well below where it was 10 years ago. Although the investment managers overseeing our portfolios are primarily bottom-up stock pickers, they are aware that the twists and turns of the Brexit saga can cause future volatility and create opportunities.

Exhibit 15: Value Makes a Run, but Still Lags Growth



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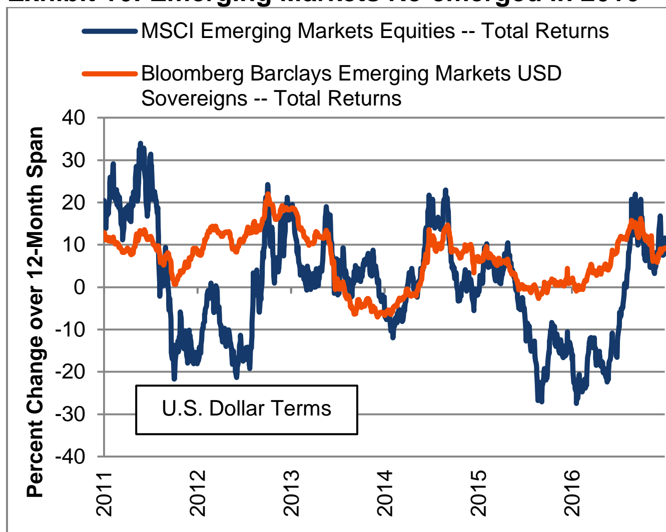
In fixed income, the biggest moves have been currency-related. Performance in dollar-terms has been hurt by the greenback's sharp appreciation. Bond prices have also fallen, with yields increasing from levels we have long viewed as unsustainably low. In all, SEI's global bond portfolios have performed similarly to their benchmarks over this period. They maintain a pro-cyclical stance, on the assumption that economic policy is turning more reflationary in much of the developed world. They are short duration in core Europe and Japan, while overweighting the U.K, Australian and Mexican bond markets owing to those countries' attractive yields versus the benchmark. Our portfolios are neutral-to-overweight corporate credits; rates have re-priced aggressively in recent months, so our positioning has shifted toward a benchmark weight. They also prefer the U.S. versus Europe from a spread perspective.

Currencies are actively managed, shifting to an overweight position in the U.S. dollar. Divergent central-bank policies and a move in the U.S. toward a looser fiscal/tighter monetary policy mix have resulted in the funding of a long U.S. dollar position through significant short positions in the euro and the yen. This positioning also serves a dual role as a hedge against an overweighted position in local-currency emerging-market debt, since directly hedging back currency risk is an expensive undertaking.

Emerging Markets Dumped After Trump

Emerging markets had a seriously negative reaction to the Trump election. Despite the decline, equity and fixed-income asset classes both recorded respective gains of 11.67% and 9.2% in U.S. dollar-terms for 2016; although year-over-year increases reached 16% for bonds and over 20% for stocks as recently as September (Exhibit 16). Concerns about the new administration's stance on trade and resumption of the dollar's appreciation are the main factors for the setback.

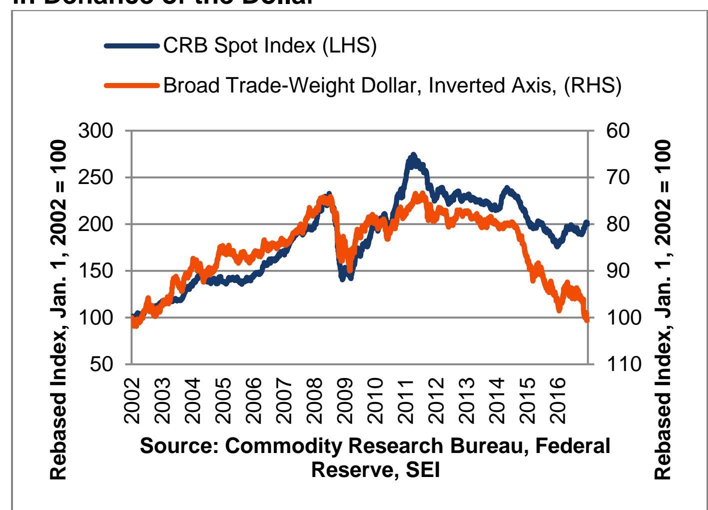
Exhibit 16: Emerging Markets Re-emerged in 2016



Sources: Bloomberg Barclays, MSCI, SEI

Surprisingly, commodity prices have been rather resilient since the U.S. elections. We wonder how long this will be the case if the dollar maintains its upward trajectory, as we expect. Exhibit 17 compares the Commodity Research Bureau's spot index (a measure that excludes the energy complex) against the broad trade-weighted value of the dollar. The axis for the trade-weighted dollar is inverted to highlight the strong (negative) correlation between the two series over the past decade or more. When the dollar appreciates, commodity prices weaken; when the dollar goes down, commodity prices tend to go up. Since the election, however, spot prices have increased even though the dollar has surged.

Exhibit 17: Commodity Prices Climb in Defiance of the Dollar



The rise in commodity prices has boosted the earnings of companies that make up the MSCI Emerging Markets Index in dollar terms; the gains nevertheless have been rather disappointing compared to the historical relationship. Exhibit 18 shows that forward price/earnings ratios for the MSCI Emerging Markets Index have risen significantly over the past two years. At 12 times the forecasted earnings for the next 12 months, emerging-market forward price/earnings ratios have recovered to their highest levels since 2010. While developed-market multiples, as measured by the MSCI World Index, still remain substantially higher at about 16 times, the relative price/earnings ratio premium enjoyed by developed countries has narrowed.

It's possible that the relative multiples gap can continue to narrow; but if emerging markets are to outperform their developed-market counterparts on a sustained basis, we think the world needs to see a major step-up in economic growth and global trade. Faster growth in the U.S. certainly helps, yet the maintenance of open markets and strong trading relationships are also crucial. The aggressive approach toward trade issues likely to be adopted by the Trump administration leaves investors with an uncertain outlook.

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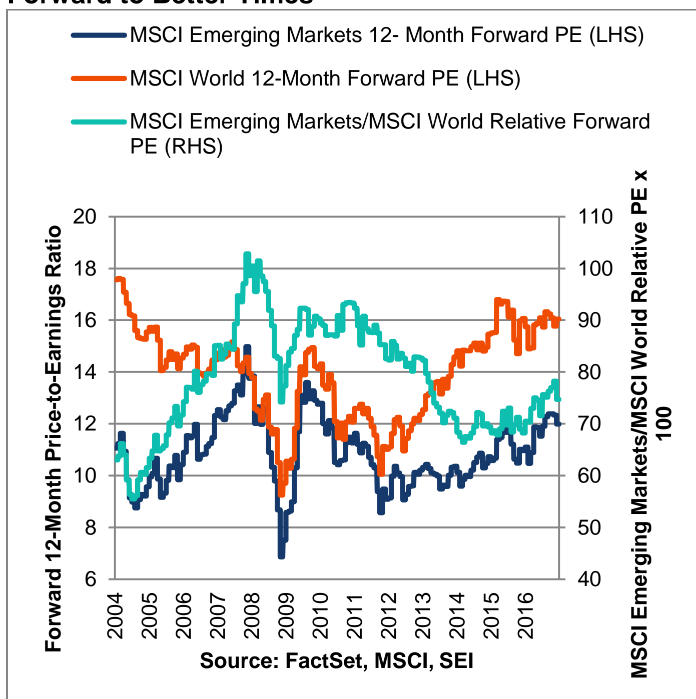
Exhibit 18: Emerging Markets Looking Forward to Better Times



It's always hard to talk in general asset-class terms about emerging markets. Each country has its idiosyncratic risks. When it comes to emerging-market investing, one must usually dive into the details of individual countries, industry groups and companies. SEI's equity portfolios are currently overweight Latin America, especially Brazil. Although Brazilian politics remains exciting amid all the corruption scandals, there is hope that Brazil's long economic recession is drawing to a close. Industrial production is still down almost 6% on a year-over-year basis, but that compares against a 12% slide over the 12 months ended February. Consumer spending may be poised for a comeback. According to Ned Davis Research, consumer confidence has risen the fastest and furthest in Brazil over the past year compared against the 26 emerging and developed economies that the firm tracks. Bond yields have come in dramatically too; the two-year Treasury note has fallen from a high of 16% earlier this year to 11.5%. On an inflation-adjusted basis, short-term rates remain high relative to other countries.

Our portfolios, by contrast, are generally underweight the Asia/Pacific region. The demise of the TPP and the confrontational tone of the incoming Trump administration toward China are probably causing short-term interest in the region to fade. Korea, Malaysia and Taiwan are all underweighted positions at this point. India, however, remains a favored area. The Modi government created a big negative stir in November as a result of its poorly implemented currency reforms. In the short run, elimination of high-denomination rupee notes is causing a fair amount of disruption in an economy that is highly cash-based. In the longer-term, it doesn't change the upbeat picture we drew in last quarter's *Economic Outlook*.

On a sector basis, SEI's emerging-market portfolios are underweight financials and utilities and overweight technology. We also like the consumer companies, but have been reducing exposure to consumer discretionary and favoring less-cyclical consumer staples. Energy has been bumped up to a slight overweight on optimism that the recent OPEC agreement will maintain pricing at a higher level in the months ahead.

On the fixed-income side, we believe the fundamentals are broadly supportive. Local-currency bonds sold off hard after the U.S. election, but yield spreads have come back in. Our portfolios remain overweight local-currency bonds. Mexican sovereign bonds, for example, are attractively valued post-election. Other countries where our portfolios have overweighted positions include Argentina, Indonesia and Brazil. As is true in equities, our bond portfolios are underweight China and Korea. With regard to currencies, they are underweight the Chinese yuan, the Korean won and the Singapore dollar. Long currency exposures include the Indonesian rupiah, the Indian rupee and the Russian ruble.

Living in Interesting Times

This time last year, we titled our *Economic Outlook* "More of the Same in 2016…With a Little Less Certainty." Perhaps we should have titled this one "More of the Same in 2017…With A LOT Less Certainty." We maintain our long-held view that equities generally will do well versus fixed-income securities, that the U.S. appears to be the cleanest shirt in the laundry bag and that yields will increase over time as inflation makes a mild comeback.

Our outlook is fraught with uncertainty, as the U.S. is on the cusp of radical change. Some of it (tax and regulatory reform) should be positive, and increases our optimism that economic growth will accelerate. Some of it (upending trade agreements and confronting China) could be dangerous unless those changes are nuanced and focused, characteristics that have not been in evidence up to this point. Although equity valuations are elevated in the U.S. versus Europe, Japan and many emerging markets, there is still confidence that earnings will grow robustly on a per-share basis, as economic growth, tax reform and cash repatriation and a sharp turnaround in energy-sector profitability push year-on-year earnings growth toward 15%, perhaps higher.

We do not anticipate a sharp rise in interest rates from current levels in the year ahead. The dollar's strength provides some brake to economic growth and should help put a cap on further acceleration in inflation that may occur. But the days of underestimating U.S. economic growth and overestimating Fed tightening moves may be drawing to a close.

In Europe, politics will be a major consideration for investors once again as voters have tired of austerity and poor economic outcomes. The presidential elections in France will be especially important. Depending on the result, we either will see a fresh approach to the country's problems, or a ramping up of the forces that threaten the euro-currency framework. The fight over the details of the U.K.'s exit from the EU also will have the potential of creating periods of market volatility and investor uncertainty.

The biggest impediment to a favorable investment environment, however, involves the changing trading relationship between China and the U.S., the two most important economies in the world. The geopolitical dimensions of the relationship cannot be ignored either. Since the election, investors have focused on the positive aspects of President-elect Trump's surprising electoral victory and the end of legislative gridlock. There will be times in the year ahead when the more worrisome and controversial initiatives pushed by the Trump administration will rattle investor confidence. If and when those times come, we would view equities as attractive.

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Index Definitions

Bloomberg Barclays EM USD Sovereigns Index: The Bloomberg Barclays Emerging Markets USD Sovereign Index tracks fixed and floating-rate US dollar-denominated debt issued by sovereign EM issuers. Corporate issues are not eligible.

Bloomberg Barclays U.S. Aggregate Bond Index: The Barclays U.S. Aggregate Bond Index is an unmanaged 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.

Bloomberg Barclays U.S. Corporate High Yield Bond Index: The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the U.S. dollar-denominated high-yield fixed-rate corporate-bond market.

Broad Trade-Weight Dollar Index: The trade-weighted U.S. dollar index, also known as the broad index, is a measure of the value of the U.S. dollar relative to other world currencies.

CRB Spot Index: The CRB BLS Spot Index tracks 22 commodities presumed to be among the first influenced by changes in economic conditions.

JP Morgan Nominal Broad Effective Exchange Rate Index: The JP Morgan Nominal Broad Effective Exchange Rate Index tracks a currency's performance in the Forex (fx) market to determine how exchange-rate changes impact the host country's inflation outlook.

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 Europe Growth Index: The MSCI Europe Growth Index captures large- and mid-cap securities exhibiting overall growth style characteristics across 15 developed-market countries in Europe.

MSCI Europe Value Index: The MSCI Europe Value Index captures large- and mid-cap securities exhibiting overall value style characteristics across 15 developed-market countries in Europe.

MSCI World Index: The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of 24 developed market country indices.

Personal Consumption Expenditures Price Index: The Personal Consumption Expenditures Price Index measures price changes in consumer goods and services

Russell 1000 Index: The Russell 1000 Index includes 1000 of the largest U.S. equity securities based on market cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.

Russell 2000 Index: The Russell 2000 Index includes 2000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.

S&P 500 Index: The S&P 500 Index is an unmanaged, market-weighted index that consists of the 500 largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market.

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