Trade Tensions Test Alliances

Monthly Snapshot

- The Trump administration cited national security concerns as it imposed steel and aluminum tariffs on the EU, Canada and Mexico in late May; this came after the expiration of a two-month waiver that had been extended to these major trading partners, which have traditionally been U.S. allies.
- The 10-year U.S. Treasury yield touched a seven-year high during the month, and West Texas Intermediate crude-oil prices climbed to their highest level since late 2014.
- The synchronized global expansion is still alive and well. Earnings have continued to climb briskly around the world.

Economic Backdrop

The Trump administration cited national security concerns as it imposed steel and aluminum tariffs on the EU, Canada and Mexico in late May; this came after the expiration of a two-month waiver that had been extended to these major trading partners, which have traditionally been U.S. allies. All three responded with rebukes and retaliatory measures in the form of tariffs on U.S. goods; additionally, the EU opened a formal case with the World Trade Organization. The Chinese government appeared to step back from assurances that it would underwrite increased purchases of American products as part of negotiations to reduce its trade imbalance with the U.S., bristling at re-proposed plans of the Trump administration to apply China-specific tariffs.

The swearing in of Italy's Prime Minister Giuseppe Conte—a relative newcomer to politics—signaled continued viability of the euro-sceptic coalition, which formed from the two populist parties that won the country's March election. Financial markets were rattled in May by the anti-EU implications of the new Italian government taking shape, then again as rejection of the coalition's first choice for economy minister seemed to set the stage for another round of elections and associated delays. Spain's government also experienced turnover as center-right Prime Minister Mariano Rajoy suffered a no-confidence vote and was replaced by socialist leader Pedro Sanchez at the beginning of June.

A Brexit proposal by U.K. negotiators for Northern Ireland to have joint EU and U.K. status was floated in an effort to avoid hard borders, but it did not appear to garner much support. Pressure intensified on the Labour Party to agitate for a second referendum once the Brexit deal is finalized, with the expectation that the 'Remain' campaign will fare better once concrete details are available.

The 10-year U.S. Treasury yield touched a seven-year high in May before settling somewhat lower by the end of the month. West Texas Intermediate (WTI) crude-oil prices climbed to their highest level since late 2014, as the U.S. backed out of a multi-party nuclear disarmament agreement with Iran and re-imposed economic sanctions; prices ultimately retreated sharply

Key Measures: May 2018

Equity		
Dow Jones Industrial Average	1.41%	↑
S&P 500 Index	2.41%	↑
NASDAQ Composite Index	5.50%	↑
MSCI ACWI Index (Net)	0.12%	↑
Bond		
Bloomberg Barclays Global Aggregate Index	-0.76%	↓
Volatility		
Chicago Board Options Exchange Volatility Index PRIOR: **15.39**	15.43	↑
Oil		
WTI Cushing crude oil prices PRIOR: **$68.57**	$67.04	↓
Currencies		
Sterling vs. U.S. dollar	$1.33	↓
Euro vs. U.S. dollar	$1.17	↓
U.S. dollar vs. yen	¥108.65	↓

Sources: Bloomberg, FactSet, Lipper

on reports that the Organization of the Petroleum Exporting Countries and Russia may reach an agreement to raise output. The spread between prices for Brent crude and WTI widened by the most since early 2015. U.S. stocks were largely alone among developed markets as they finished May in positive territory; Europe was considerably negative, while the U.K. was also down. Emerging-market equities performed even worse, especially in Latin America. The U.S.-versus-everywhere-else divide extended to performance in the fixed-income universe as well.

The Federal Reserve (Fed) took no new monetary policy actions following its early-May meeting, but asserted willingness to let inflation run above its 2% target in the short-term. The Fed met late in the month to begin unwinding parts of the Volcker Rule, a regulation imposed by the U.S. government after the financial crisis that sharply limited banks from proprietary trading. The Bank of England's Monetary Policy Committee held firm in May, while the European Central Bank and Bank of Japan had no meeting on monetary policy during the month.

Reports of U.S. manufacturing growth were mixed but generally strong. The unemployment rate ticked down to 3.8% in May, the labor-force participation rate declined, and average hourly earnings improved. Consumer spending increased in April as consumer price measures remained near the Fed's inflation target. A second estimate of first-quarter economic growth edged down to an annualized 2.2% rate.

U.K. manufacturing growth accelerated in May following the prior month's trough, while construction gains were unchanged. Consumer prices increased by 0.4% in April, touching recent monthly highs, but year-over-year inflation dropped to 2.4%. The jobless claimant count edged up to 2.5% in April, while the unemployment rate for the January-to-March period held at 4.2%; average year-over-year earnings growth slid to 2.6% for the three-month period ending March. First-quarter economic growth dropped to 0.1%, the slowest quarterly pace in more than five years, and to 1.2% year over year.

Eurozone manufacturing growth continued to slide in May from its December peak, settling to its lowest level since early 2017; services-sector activity appeared to follow a similar trajectory, based on preliminary data for May. The unemployment rate fell to 8.5% in April following an upward revision to the March figure. A preliminary economic-growth estimate was recorded at 0.4% for the first quarter and 2.5% year over year; both numbers were 0.2% below their respective levels in the prior quarter.

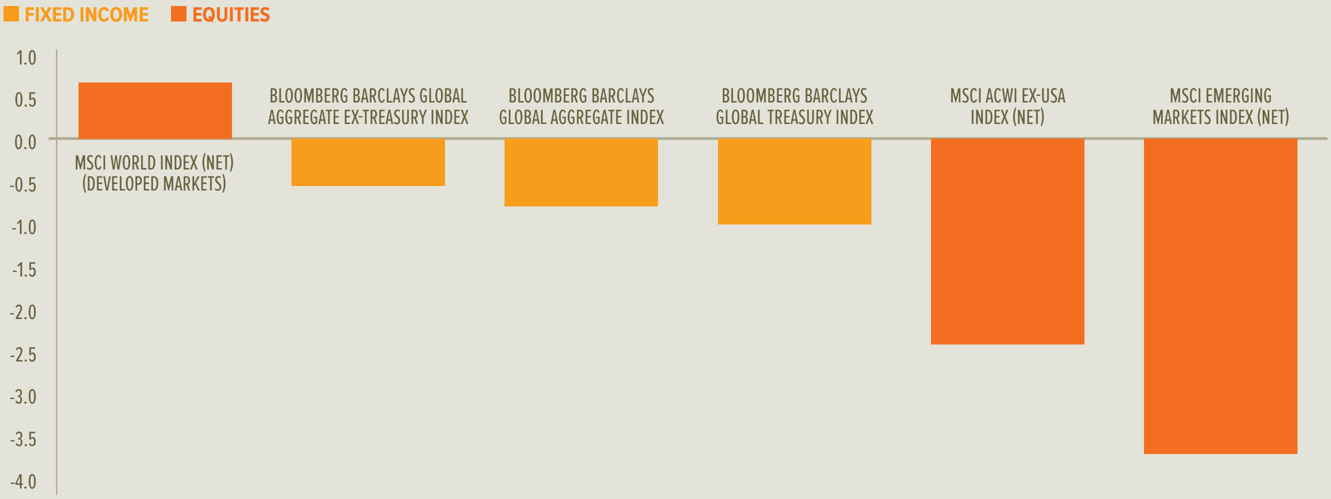
Portfolio Review

U.S. equities outperformed the rest of the world in May, building on their modest April rebound. Our large-cap strategy underperformed due to an underweight to technology, top-performing sector. Stock selection within technology and healthcare also detracted. Our small-cap strategy performed in line with the benchmark's breakneck advance, with value-oriented managers held back by style headwinds and momentum managers benefitting from the trend. International developed-market equities fared poorly in May, but our strategy was able to mitigate a significant portion of the decline. Selection in Europe was helpful, particularly among French, Spanish and German stocks; from a sector standpoint, positioning in financials, industrials and technology contributed. Emerging-market equities tumbled even more, and we were able to outpace benchmark performance there as well. Strong selection in Asian stocks contributed, especially in China; an overweight to technology and selection in industrials and materials helped, while retail positioning detracted.

International developed-market equities fared poorly in May, but our strategy was able to mitigate a significant portion of the decline.

Our core fixed-income strategy essentially matched the benchmark during a positive month for U.S. investment-grade bonds, where U.S. Treasurys outperformed most non-government sectors. Yields moved lower for the month, rising to post-crisis highs before ultimately retreating; a modestly long duration positioning was therefore a small contributor, and a yield-curve-flattening bias helped as long-term yields fell by more than short-term yields. An overweight to corporate financials detracted as spreads widened slightly in May. Within the securitized sectors, an allocation to non-agency mortgages and an overweight to asset-backed securities (ABS) contributed as both areas outperformed; however, a higher-quality bias within commercial mortgage-backed securities (CMBS) detracted as lower-quality tranches outperformed. An underweight to taxable municipals, which outperformed on reduced issuance, also held back returns. Our high-yield strategy improved on near-flat benchmark performance due to a bank-loan allocation as well as positioning within banking and retail. Underweights to and selection within healthcare and transportation partially held back our outperformance, as did selection in services. Emerging markets were the weakest link in fixed income; our relative performance lagged given an overweight to local-currency-denominated emerging-market debt amid a U.S. dollar rally. Underweights to Eastern

Major Index Performance in May 2018 (Percent Return)



Sources: FactSet, Lipper

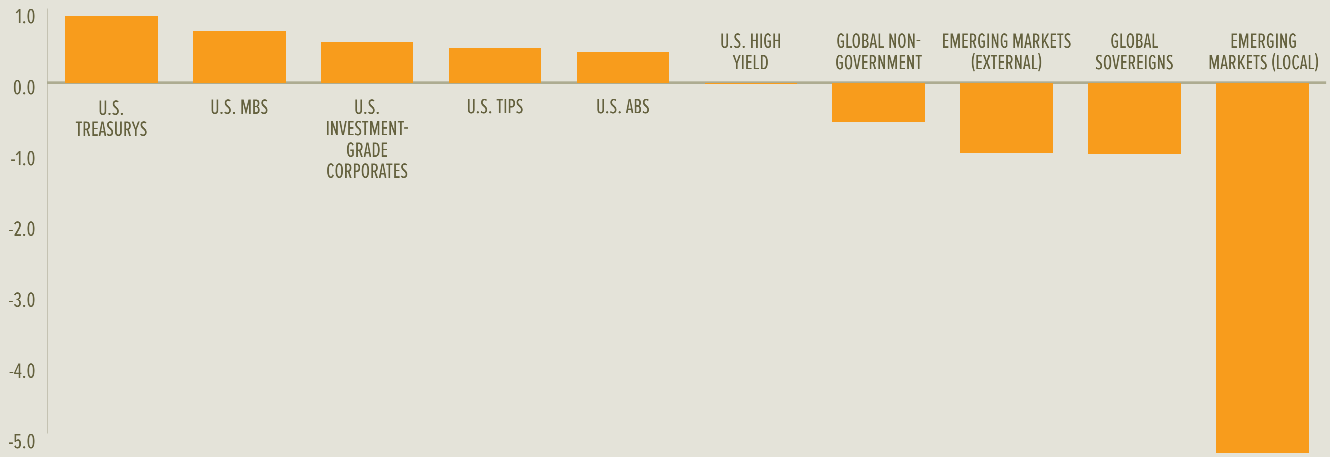
European local sovereign bonds helped relative performance, particularly those in Hungary and Romania; overweights to Turkey and Argentina detracted.

Manager Positioning and Opportunities

U.S. equity valuations have been high relative to international markets and historical averages, yet compressed slightly by recent strong earnings growth. Markets may return to volatile conditions due to high valuations, rising interest rates, trade tensions, and potential geopolitical instability, which we believe calls for slightly more conservative positioning. Overseas, our developed-market strategy has continued to favor themes with structural tailwinds—such as growth of the internet and digital services, which has driven an overweight to technology; and global economic expansion, which has led to an overweight to industrials (specifically commercial and professional services and transportation). Traditional defensive sectors remained underweight as they offered less growth opportunities. These themes carried over to our emerging-markets equity strategy—where positioning in the banking sector emphasized companies in India and Greece, but limited exposure to China. We trimmed overweight exposures to Brazil and India, but retained some ex-benchmark exposure to Argentina.

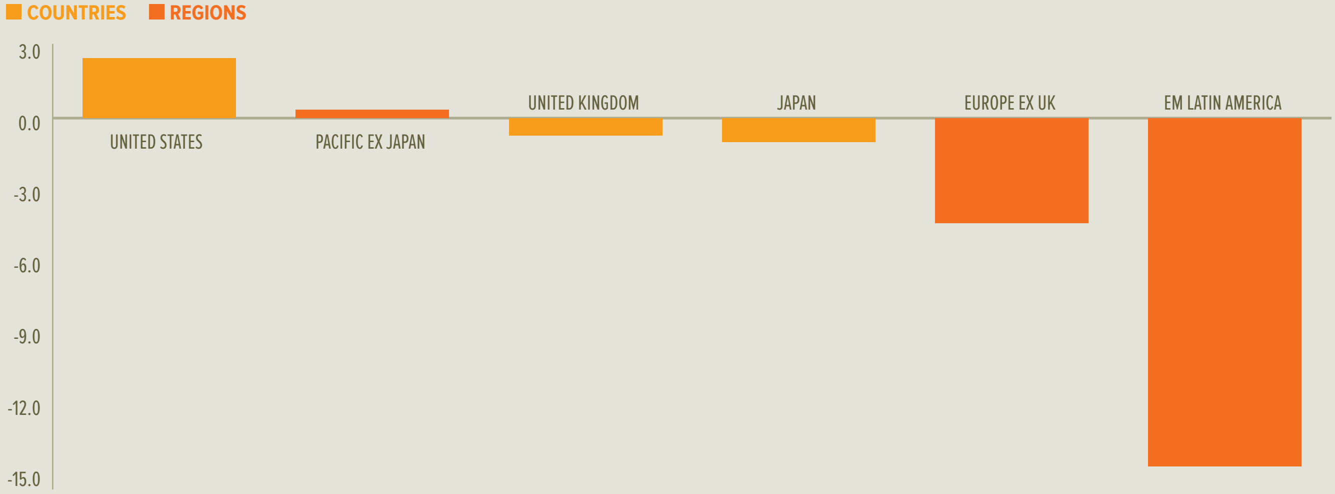
Our core fixed-income strategy slightly added duration in mid-May as yields rose; we continued to gradually reduce our yield-curve-flattening bias, as the curve flattened through 2017 and in the year to date. Banking remained our largest corporate overweight, while industrials and utilities were closer to neutral or slightly underweight. Overweights to ABS and CMBS remained—with an emphasis on higher-quality, given their attractive risk-adjusted yields. We retained an allocation to non-agency mortgages, and have been adding to agency mortgages as managers continued to trim

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



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

risk. Our high-yield positioning emphasized bank loans as well as media, leisure, insurance and retail. Energy, financial services, banking and basic industry represented the largest underweights. Within emerging markets, we remained significantly overweight to local-currency debt. Argentina, Mexico and Egypt were our largest country overweights, while Hungary, Philippines and Romania were our most significant underweights.

Our View

We suspect the bull market in U.S. equities is somewhere near the beginning of the end, while it may be somewhat closer to the end of the beginning in other countries. To be clear, we are not saying that the bull market in U.S. stocks is concluding. Rather, we are noting that the fundamental, technical and psychological factors driving equity-market performance appear consistent with the latter stages of an up cycle. This particular phase can last a few years if all goes well, but the ride will likely be bumpier than in recent years. We still do not see many serious signs of overvaluation or economic imbalances in the U.S. that would suggest imminent danger of a severe correction, much less a devastating bear market on par with the 2008-to-2009 experience.

Although equity markets underwent their first real correction in some 20 months during the first quarter, the pullback does not look like the start of a more serious decline. At SEI, we see two fundamental drivers behind the correction in equities and the return to more-volatile price action. The first is the upward shift in investors' interest-rate expectations as the global economy kicks into a higher gear. The second is concern that the Trump administration's recent actions on the trade front will lead to a broader trade war that could hurt global growth and push inflation higher sooner.

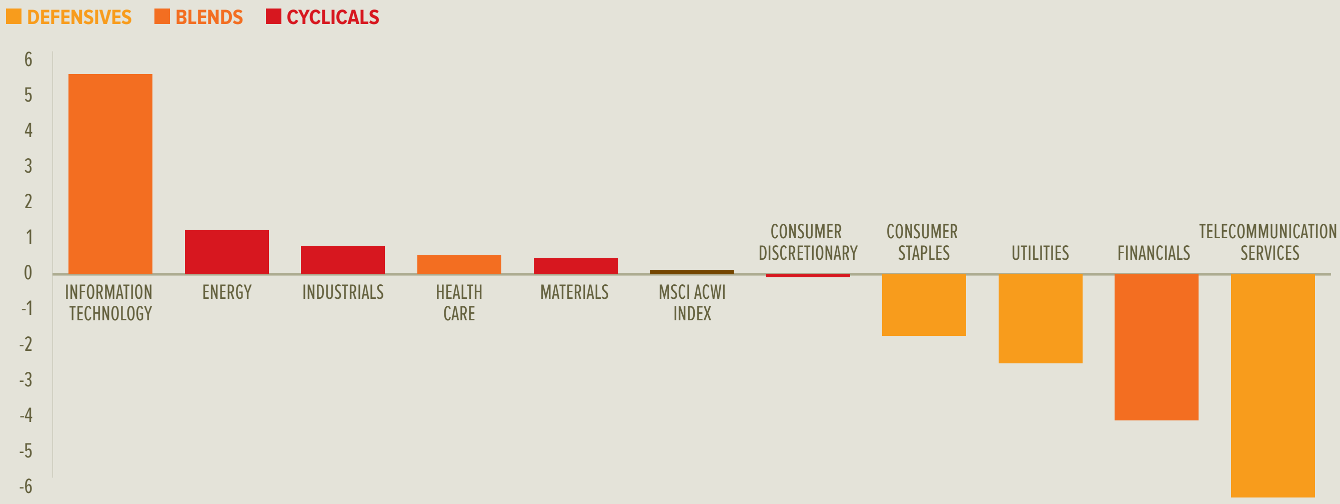
There certainly are cyclical pressures pushing yields up from their historic lows. The long bull market in equities and other risk-oriented assets has been sustained by the extraordinarily expansive monetary policies of the world's most important central banks. And the subsequent decline in yields across the maturity spectrum reached levels never seen before. In our view, this 37-year tailwind is turning into a headwind.

But the Treasury yield curve remains upward sloping and, in our opinion, can narrow further without causing too many problems. Interest-rate spreads for investment-grade, high-yield and emerging-market debt also remain near cycle lows. High-yield bonds, in particular, should be considered the canary in the coal mine. Spreads tend to widen well before the stock market tops out. Even during the recent turbulence in the stock market, the option-adjusted spread on high-yield bonds held surprisingly steady.

As we have pointed out on several occasions in the past, the U.S. equity market has historically managed to withstand the depressive impact of rising interest rates until the 10-year Treasury reaches a level of 4% to 5%. Owing to the structural decline in bond yields and the elevated equity valuations that have resulted, we now think it prudent to assume that the stock market will begin to struggle if the 10-year Treasury rate approaches 4% (the lower end of the traditional "danger zone").

While we maintain a positive view of equities and other risk assets, we must admit that our optimism is being tested as the Trump administration uses protectionism as a bargaining tool against friend and foe alike. Impediments to trade—tariffs, quotas and non-tariff barriers—raise prices and reduce demand, leading to a dead-weight loss for society. More jobs are lost by consuming industries than are gained by the beneficiaries of protectionism. A trade war of consequence could add to the inflation pressures that have already emerged as a result of the pick-up in economic activity and the tightening employment situation.

Global Equity Sector Performance in May 2018 (Percent Return)



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

We are in watchful-waiting mode when it comes to trade, but think it's premature to expect a catastrophe. Our preference is to see what trade sanctions are actually levied, and how target countries respond, instead of assuming the worst from the get-go. Until there is more clarity on the extent of the U.S. protectionist measures being put into place, we think it's best to focus on the strong fundamental backdrop. Profit growth remains vibrant, inflation is still well-contained and the Fed's decision makers would prefer to normalize monetary policy in a steady, predictable fashion. For now, we believe it's proper for us to maintain a "risk-on" investment orientation.

We may have finally begun to see a shift away from the poor relative performance of eurozone equities that has persisted since the middle of last year. The eurozone economy has been gaining traction since early 2016; we judged the potential for future growth to be much greater in the eurozone than in the U.S. given their respective points in the economic cycle. We also looked for a jump in earnings, as European companies have a high degree of operational leverage, while valuation considerations also provided support to our bullish rationale.

On a fundamental basis, we think investors remain skeptical about the staying power of the European expansion. The European Central Bank is moving away from the asset purchases that have supported the eurozone's economic recovery and credit markets. And by mid-year 2019, if not sooner, we should see the first steps toward normalizing policy rates—although negative yields are an absurdly low starting point. While the outlook for the eurozone is mixed, it seems bright and sunny compared to that of the U.K. As we have mentioned in previous reports, Brexit has become the overwhelming obsession of investors and policymakers.

Congressional elections will take place in November, potentially jeopardizing current Republican control of the House of Representatives. Legislating in the U.S. has been tough enough under a "unified" government; it will become next to impossible under split governance, should power become more evenly distributed across the two major parties. We would also expect a Democratic House to ramp up the pace of investigations into the president, his staff and his Cabinet.

The past nine years have been full of challenges and uncertainties. The years ahead don't seem to promise anything different in that regard. Yet the bull market has managed through it all. Let's give it the benefit of the doubt for a while longer. Although the ride has turned bumpier, we believe that economic fundamentals justify further gains in U.S. and global equity prices. The synchronized global expansion is still alive and well. Earnings continue to climb briskly around the world. U.S. companies' cash flows and earnings, meanwhile, are benefiting mightily from the tax reform passed late last year by the U.S. government. There really are few signs that a recession will rear its ugly head anytime in the next 12 to 18 months.

The past nine years have been full of challenges and uncertainties. Yet the bull market has managed through it all. Let's give it the benefit of the doubt for a while longer.

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 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 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.

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.

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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