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MONTHLY MARKET COMMENTARY | JANUARY 2018

January Hot Streak Ends on a Cold Note

Monthly Snapshot

- Equities were generally stronger around the world in January, but experienced a significant risk-off move near the end of the month that reverberated through the beginning of February.
- Major developed-market government-bond rates advanced across essentially all maturities. Local-currency-denominated emerging-market debt was the best-performing segment of the fixed-income universe, while U.S. Treasurys lagged.
- Rather than worry about the stock market's valuation, or trying to time the market in anticipation of a short-term correction, we believe it's better to focus on long-term investment goals.

Economic Backdrop

The U.S. government shut down for several days in the middle of January before congressional Republicans and Democrats agreed to pass another stopgap spending bill that was expected to last for three weeks. The Trump administration announced tariffs on imported solar panels and washing machines in a move designed to protect American manufacturers from lower-priced overseas competition, garnering mixed responses. The president also openly contemplated renegotiating membership in the Trans-Pacific Partnership trade agreement after bowing out a year ago. Fourth-quarter earnings appeared strong: three-quarters of S&P 500 Index constituents that reported their numbers thus far (about half as of February 2) pointed to positive earnings surprises; an even higher number of companies had favorable sales surprises.[1] U.S. oil production in November, reported on the last day of January, topped 10 million barrels per day for the first time since 1970.

U.K. Prime Minister Theresa May announced plans in late January to limit the free movement and residency rights of European Union (EU) citizens starting in the post-Brexit transition period despite demands from EU negotiators for status quo through the end of 2020. An impact report prepared for the Department for Exiting the EU was leaked to the media, painting a bleak picture of potential Brexit outcomes for the U.K. economy. Negotiations over the formation of a grand coalition in Germany continued through month-end, with the expectation of a pact in early February—indicating the likely continuation of pro-EU government in Europe's largest economy. Italy's euro-sceptic Five-Star Movement, the best-polling individual party heading into an early March election, dropped a promise to hold a referendum on pulling Europe's third-largest economy out of the euro. Conservative parties are expected to win the largest combined share of votes, however, and form a governing bloc; some anticipated coalition members are still weighing a euro departure.

Federal Reserve (Fed) Chair Janet Yellen presided over her last monetary policy meeting on January 31 (at which no changes were made), as her four-year term came to an end. The European Central Bank (ECB) and Bank of Japan (BOJ) similarly announced no changes to their policy programs.

[1] *FactSet: Earnings Insight.* Butters, John. February 2, 2018.

Key Measures: January 2018

Equity	
Dow Jones Industrial Average	5.88% ↑
S&P 500 Index	5.73% ↑
NASDAQ Composite Index	7.40% ↑
MSCI ACWI Index (Net)	5.64% ↑
Bond	
Bloomberg Barclays Global Aggregate Index	1.19% ↑
Volatility	
Chicago Board Options Exchange Volatility Index PRIOR: 11.04	13.54 ↑
Oil	
WTI Cushing crude oil prices PRIOR: $60.42	$64.73 ↑
Currencies	
Sterling vs. U.S. dollar	$1.42 ↑
Euro vs. U.S. dollar	$1.25 ↑
U.S. dollar vs. yen	¥109.16 ↓

Sources: Bloomberg, FactSet, Lipper

The BOJ kept its quarterly economic projections steady; although the central bank's announcement in early January of reduced long-term bond purchases propelled yields and the yen upward (yields and prices move inversely). The Bank of England's (BOE) Monetary Policy Committee had no January meeting.

Equity markets were generally higher around the world in January, but experienced a significant risk-off move near the end of the month that reverberated through the beginning of February. Major developed-market government-bond rates advanced across essentially all maturities. The 2-year Treasury yield rose above 2% for the first time since September 2008, and the 10-year yield reached its highest level in almost four years; the 30-year yield, while elevated, remained below its 2017 peak. The U.S. dollar continued to slide, touching its lowest level (against major foreign currencies on a trade-weighted basis) in more than three years.

The solid pace of growth in U.S. manufacturing activity was essentially maintained in January, while non-manufacturing growth accelerated by far more than expected. Unemployment held at 4.1% in January, and average-hourly-earnings growth accelerated to a 2.9% year-over-year rate. Personal-income growth increased in December, while consumer-spending growth decelerated and inflation pressures appeared to remain contained. Employment costs were reported near the high end of their expected ranges in fourth-quarter productivity reports. The first estimate of fourth-quarter economic growth indicated a 2.6% annualized rate, which was a disappointment following the 3.2% pace in the third quarter.

U.K. services sector activity slowed during January, but remained firmly in expansion territory, while construction growth decelerated to just above a standstill. Manufacturing growth also moderated, but at healthier levels. Claimant count unemployment edged down in December from the prior month's upward-revised figure, pushing the rate higher. The September-to-November unemployment rate and average earnings growth for the one-year period ending November were unchanged—at 4.3% and 2.5%, respectively—from the previous report. The British economy grew by 0.5% in the fourth quarter, according to an early estimate, improving slightly compared to the prior three-month period.

Eurozone momentum carried into the New Year as services sector growth hastened to impressive levels and manufacturing growth (while modestly lower) also showed remarkable strength. The unemployment rate was an unchanged 8.7% in December; however, 134,000 Europeans found work during the month (almost matching November's upward-revised gain) and the youth unemployment rate declined. Preliminary overall fourth-quarter economic growth was measured at 0.6% (and 2.7% year over year).

Portfolio Review

U.S. equities advanced during the month, led by large caps, while growth stocks continued to outpace value. Our large-cap strategy performed well, primarily via an underweight to high-dividend-yielding (and thus interest-rate-sensitive) sectors such as utilities, telecommunications and real estate, which lagged as interest rates increased. Selection within the technology sector was also beneficial. Our small-cap strategy was challenged by selection within the energy, consumer discretionary and healthcare sectors. Overseas, developed markets mostly kept pace with U.S. large caps, and our international strategy lagged due to selection in airline, semiconductor and energy stocks. Positioning in financials (especially Italian banks) partially offset these weak spots. Regionally, selection in Japan and ex-benchmark countries also detracted. Emerging markets performed best; our strategy was held back by exposure to technology stocks that came under pressure, and by selection within the consumer sectors.

The U.S. investment-grade bond markets slid in January; our core fixed-income strategy fared relatively well, as non-government sectors generally outperformed comparable Treasurys. A slightly shorter-duration posture and yield-curve-flattening bias enhanced returns as short-term yields increased by more than long-term yields. Selection in and an overweight to financials contributed, while an underweight to industrials moderately detracted. An allocation to non-agency mortgage-backed securities (MBS) was additive, while positioning in underperforming agency MBS was a drag on performance. An overweight to asset-backed securities (ABS)—tempered by an underweight to sub-prime auto securitizations (which have seen increased delinquency rates) and an allocation to student loan securitization—was beneficial. The strategy gained on an overweight to commercial MBS (CMBS); however, our higher-quality bias weighed on returns, as did underweights to taxable municipals and sovereign issuers.

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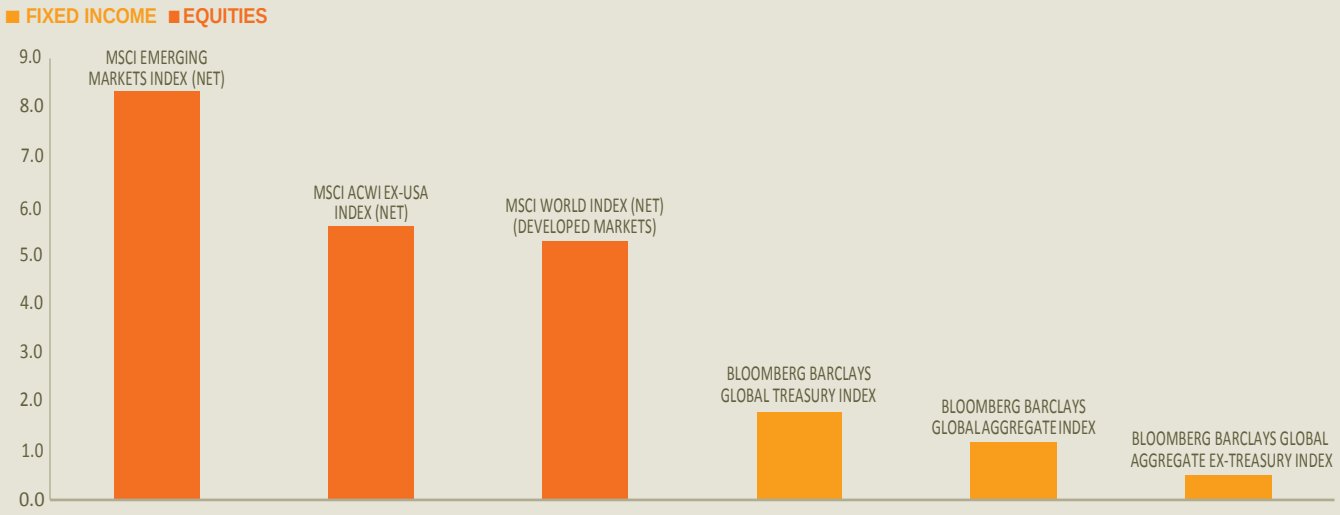
Major Index Performance in January 2018 (Percent Return)



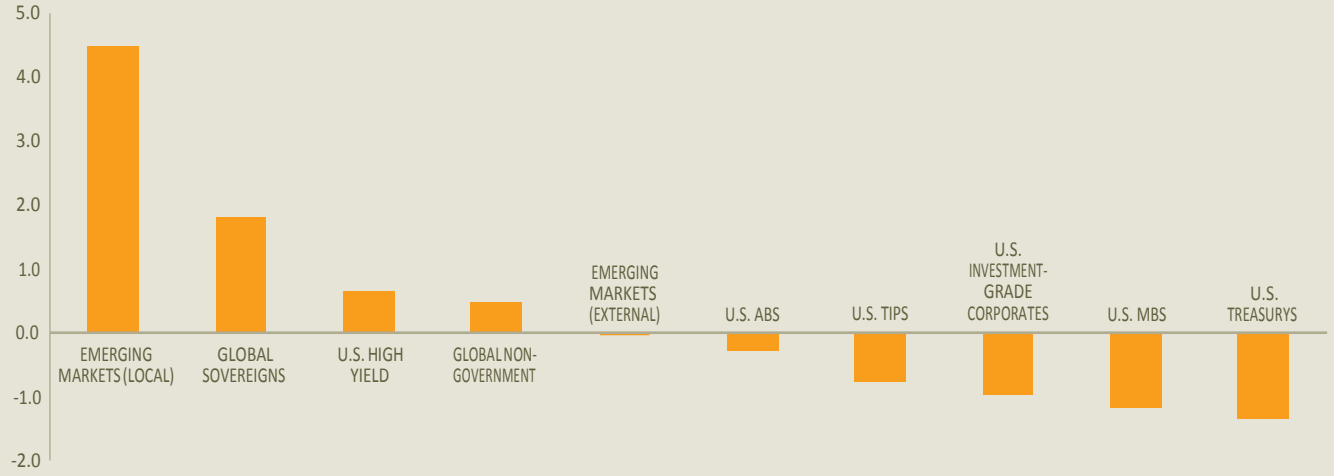
Sources: FactSet, Lipper

The high-yield market was strong; our strategy performed well, due primarily to an allocation to collateralized-debt obligation and selection in basic industry and technology and electronics. Positioning in healthcare and energy detracted somewhat. Emerging-market debt had a solid month; our strategy outperformed given a continued emphasis on local-currency bonds as the U.S. dollar weakened. Specifically, an overweight to Brazilian local debt and an underweight to Philippines local debt contributed, while an underweight to Hungarian local debt and an off-benchmark position to Qatar detracted.

Manager Positioning and Opportunities

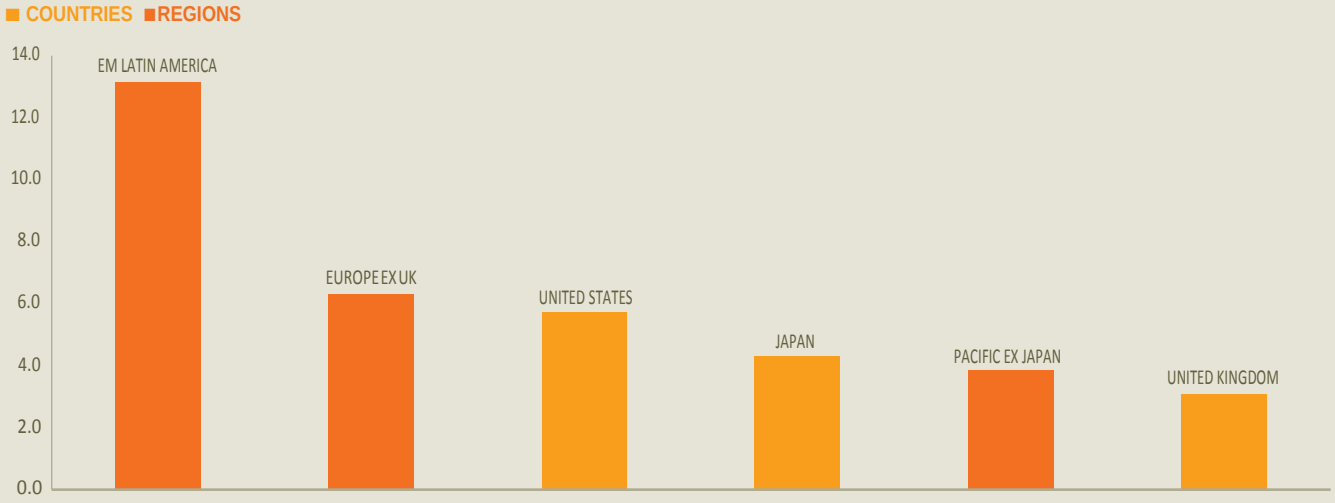
The U.S. economic environment and earnings landscape remain favorable but, as we have noted for some time, markets are at risk due to stretched valuations, rising interest rates and disruptive geopolitical events. Our large-cap strategy maintained its value orientation and underweight to defensive sectors with high dividend yields and elevated interest-rate sensitivity. Our small-cap strategy was also positioned to reflect a cautious outlook by favoring stability and momentum, and preserving weights to high-conviction value managers. Positioning in our international developed-market strategy was mostly unchanged in January—only slightly reducing an overweight to growth and momentum stocks and maintaining a small underweight to value and defensive stocks. Regionally, Japan and Australia remained underweight, and financials was still the largest sector underweight. Within emerging markets, we retained an underweight to Asia (mostly via Taiwan, Malaysia and Korea) and an overweight to India. We remained overweight to Latin America, with ex-benchmark exposure to Argentina.

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



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

Our core fixed-income strategy continued to gradually reduce its yield-curve-flattening bias, as the curve flattened during 2017. We remained slightly overweight to corporates, with an overweight to banking offset by neutral-to-underweight exposures to industrials and utilities. Overweights to ABS and CMBS remained, with an emphasis on higher-quality securities, given their competitive risk-adjusted yields. We also maintained an allocation to non-agency MBS and had a neutral weight to agency MBS. Managers were generally in gradual risk-reduction mode, waiting for an opportunity to add risk at more attractive valuations. Within emerging markets, an overweight to local-currency debt was stable through January. Our largest country overweights were to Argentina, Brazil, Czech Republic and Egypt, while the most significant underweights were to Philippines, Hungary and Peru.

Our View

The global financial crisis finally appears to be in the rear-view mirror. In its place is synchronized expansion across most developed and emerging economies. Admittedly, developed economies continued to run at a rather sluggish pace of 2% to 2.5% gross domestic product (GDP) growth. This is, at best, a middling sort of performance in the context of the past five decades. Emerging-market economies, meanwhile, continued to expand at a clip well below that of the past 20 years. Over the next year or so, we think global growth can still be vibrant enough to allow risk assets to perform well.

U.S. tax legislation is hardly perfect: we do not expect it to be as stimulative as advertised since tax cuts are skewed toward upper-income tax payers who tend to have a higher saving rate than the median household. But the permanent corporate tax changes, repatriation holiday, and the full expensing of capital equipment purchases over the next five years are positive developments for economic growth and investment.

Security analysts, always an optimistic lot, are calling for an 11% rise in S&P 500 Index per-share operating earnings in 2018. Although earnings estimates tend to fade through the year as estimates adjust to reality, this time may be an exception because tax cuts have not yet been taken fully into account.

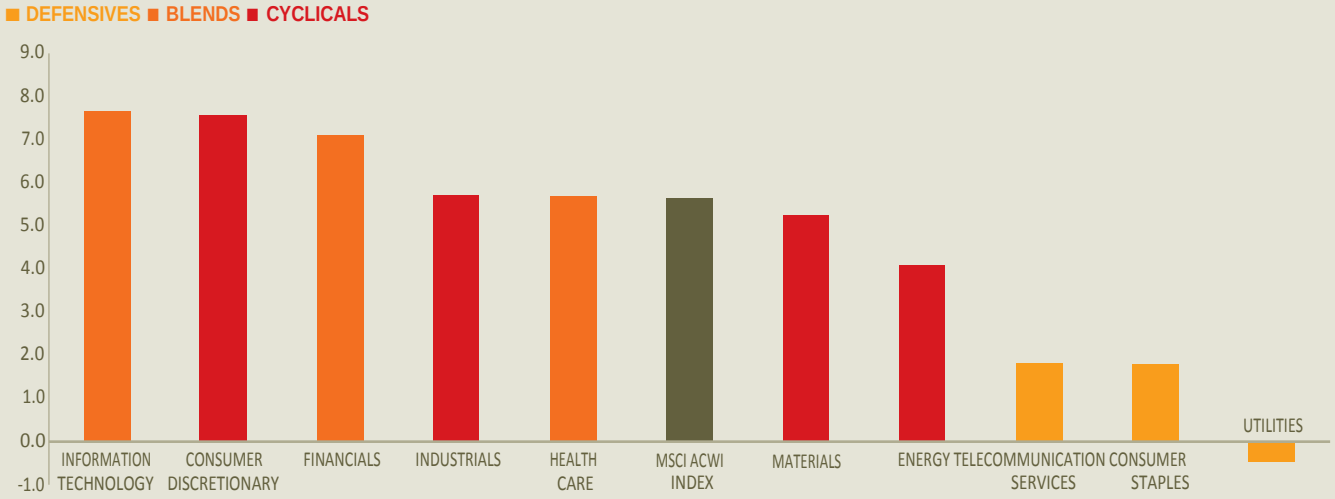
The major worry for investors comes down to the stock market's valuation. A little more than three-fifths of the S&P 500 Index's price gain in 2017 came from improving earnings, while the rest was due to a rise in the price-to-earnings (P/E) ratio. But elevated valuations can be justified by the low level of bond yields and the strong trend in profits growth. Of course the higher the valuation, the more vulnerable the stock market becomes to unexpected bad news. The market is overdue for a correction—in 2017, the S&P 500 Index didn't even register a price pullback of 3%—and we have already witnessed a peak-to-trough decline of greater magnitude from late January through the beginning of February.

We won't be really concerned, though, unless we see a more aggressive swing in Fed policy toward monetary tightness—something we don't anticipate in the coming year. It's possible that the U.S. will see inflation pressures finally begin to build in the New Year, but U.S. companies have proven able to maintain profit margins without resorting to price increases.

In our opinion, Europe has more growth potential than the U.S. According to the World Economic Forum's annual report on global competitiveness, the high-income countries of Western Europe have made important strides in improving labor-market efficiency over the last five years. We also would note that political concerns in the eurozone are far more muted compared with a year ago, although we have not yet seen the end of the heavy anti-establishment undercurrent.

Given our view that the region is a long way from employment levels that will stir inflation pressures, we expect monetary policy to be supportive

Global Equity Sector Performance in January 2018 (Percent Return)



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

of growth throughout the coming year—even as the ECB proceeds with tapering its quantitative-easing program. Since we expect these asset purchases will continue at least until the end of September, it appears that policy rates will stay put until 2019.

We therefore believe the path is clear for further economic growth in the year ahead. The strong 2017 revival in corporate revenues and earnings should continue; the MSCI European Economic and Monetary Union Index (Total Return) forward P/E ratio was no higher as of December 31, 2017, than it was a year earlier. Solid economic growth and cheap equity valuations are usually a good combination for investors.

These have not been easy days for U.K. Prime Minister Theresa May. The divorce stage of Brexit talks has finally concluded, with the U.K. mostly acceding to the EU's demands. But Parliament has begun to flex its muscles—and disapproval there would force the parties back to the negotiating table. Keep in mind that any changes to the withdrawal agreement demanded by Parliament would require unanimous approval of the 27 members of the EU on the other side of the negotiating table.

The BOE's Monetary Policy Committee forecasted only two rate increases between now and the end of 2019. While time will tell whether the central bank's view regarding future policy moves are accurate, policymakers in the U.K. face tremendous challenges over the next few years. We think investors should tread lightly until there are clearer signs that inflation pressures have peaked and Brexit negotiations actually yield a favorable economic outcome for the country.

Japan is clearly benefiting from the global economic recovery. Exports to China are growing particularly quickly, and are now about equal to the share going to the U.S. Exports to the U.S. and Europe also have accelerated, but not to the same extent.

Although there have been rumblings that the BOJ would like to take a step away from the extraordinary monetary policies that have been in place since the financial crisis, the central bank may find it difficult to do so. Domestic demand remains weak and the population has begun contracting, a trend that will likely accelerate.

Japanese equities did well last year. Remarkably, the forward P/E ratio declined since the beginning over the course of 2017 despite the improvement in economic fundamentals. It remains one of the more-cheaply valued stock markets among developed countries. Forward-earnings estimates have climbed sharply in the past year; we note that revenue estimates are also inflecting higher.

Emerging-market equities climbed significantly last year, with a particularly strong contribution from China. Despite some backsliding last year, China has continued to reduce its dependence on heavy industry and increase the value added to GDP from service-producing industries. While these macro statistics need to be taken with a grain of salt, it appears that China's growth has accelerated significantly from two years ago and is advancing

When speaking to investors who are nervous about the stock market's valuation, we urge them to keep a longer-term focus. Timing the market in anticipation of a short-term correction should be discouraged.

at its fastest clip since the 2012 to 2013 period. If China can maintain positive momentum, commodity prices should continue to rally as well.

We have held a positive view of risk assets for most of this long bull market. When speaking to investors who are nervous about the stock market's valuation, we urge them to keep a longer-term focus. Timing the market in anticipation of a short-term correction should be discouraged. As we've seen in the past year, making a major de-risking move could result in a significant opportunity-loss when there are few, if any, signs of major economic imbalances or frothy valuations. Until we see a more significant deterioration in the economic and financial fundamentals that have underpinned the global bull market in risk assets over the past two years, our default investment stance is to stay the course.

There are many possible events and developments that could have a big negative impact, but most have a low probability of actually happening. We will therefore maintain our "risk-on" bias until we see evidence that such a stance merits revision.

Glossary of Financial Terms

Duration: 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.

Price-to-earnings (P/E) ratio: The Price-to-Earnings Ratio is equal to market capitalization divided by after-tax earnings. The higher the P/E ratio, the more the market is willing to pay for each dollar of annual earnings.

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)

Disclosures

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