

Equities Jump, Bonds Dump to End 2016

Quarterly Snapshot

- › There were plenty of headlines during the quarter, including U.S. election results, a Federal Reserve (Fed) rate hike and an oil production cut led by the Organization of the Petroleum Exporting Countries.
- › Fixed-income markets struggled with the notable exception of U.S. high-yield bonds, while equities overall posted gains despite uneven performance across sectors and countries.
- › 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.

Economic Backdrop

The final quarter of 2016 offered several landmark developments: a surprise outcome to a sharp-elbowed U.S. presidential election handed firm control of the federal government to Republicans, bolstering a substantial rally in U.S. stocks and downturn in bond markets; the U.K.'s Brexit timeline and negotiating posture evolved from abstract to relatively firm as a High-Court decision subjected the plan to Parliamentary approval; and the oil-price recovery found solid footing as Organization of the Petroleum Exporting Countries (OPEC) members and non-members agreed to cut production.

Major central banks made headlines, most notably with the Federal Open Market Committee's rate increase and firmer policy-tightening projections for 2017 as the U.S. dollar continued its run-up. The European Central Bank (ECB) announced an extension of its asset-purchase program, further loosening its monetary-policy stance; although at a lower level (which could be considered tightening), sending mixed signals. The Bank of England (BOE) announced no changes, and Governor Mark Carney quashed rumors of his resignation (at least until Brexit negotiations conclude in 2019). The Bank of Japan, arguably 2017's most intrepid policy tester, had a quiet quarter as the yen continued to depreciate.

U.S. labor-market conditions continued to improve as the unemployment rate decreased by 0.3% to 4.6% in November. Consumer prices rose by 0.2% in November and by 1.7% in the year over year. Energy advanced by 1.2%, led by gasoline, while food prices were flat. Producer prices lifted 0.4% in November despite energy's stumble. Retail sales inched up by just 0.1% in November. Auto sales, which had been a driving force in previous months, had its sharpest decline since March, dropping by 0.5%. However, consumer spending remained strong, with restaurant spending and furnishing/furniture spending both posting impressive gains. November's industrial-production reading was weak, falling 0.4%. Mining gained 1.1% in the month, but could not overcome anemic motor-vehicle production, which slid 2.3%; consumer-goods production and business-equipment production also disappointed. The final release of real gross domestic product (GDP) revealed the economy grew at a 3.5% annualized rate in the

Key Measures: Q4 2016

EQUITY	
Dow Jones Industrial Average	8.66% ↑
S&P 500 Index	3.82% ↑
NASDAQ Composite Index	1.66% ↑
MSCI AC World Index (Net)	1.19% ↑
BOND	
Bloomberg Barclays Global Aggregate Index	-7.07% ↓
VOLATILITY	
Chicago Board Options Exchange Volatility Index	14.04 ↑
<small>PRIOR: 13.29</small>	
OIL	
WTI Cushing crude oil prices	\$53.72 ↑
<small>PRIOR: \$48.24</small>	
CURRENCIES	
Sterling vs. U.S. dollar	\$1.24 ↓
Euro vs. U.S. dollar	\$1.06 ↓
U.S. dollar vs. yen	¥116.64 ↑

Sources: Bloomberg, FactSet, Lipper

third quarter, stronger than prior estimates and a significant improvement over the second quarter's 1.4% growth.

The U.K. unemployment rate dipped to 4.8% in October, markedly lower than the 5.2% rate from a year earlier and the lowest level since September 2005. Consumer prices in the U.K. climbed 0.2% in November, largely due to clothing and footwear price increases. Year-over-year prices received a 0.3% boost, bringing them to 1.2%, the highest level since October 2014. Producer prices were subdued. Aside from petroleum prices, which fell by 1.1%, output prices were muted. Input costs dropped by 1.1% for the month, with their annual rate increasing to 12.9%. Retail sales in the U.K. decelerated in November, rising just 0.2% in the month. Third-quarter economic growth expanded in its final estimate, reaching 0.6% for the period.

Eurozone inflation hit 1.1% in December, marking the highest annual rate in more than three years. Markit Economics' eurozone manufacturing purchasing managers' index strengthened to 54.9 in December. The reading, which reached its highest level since April 2011, indicates sharp improvements in output, new orders and employment. Depreciation in the euro improved competitiveness, according to producers. The latest third-quarter GDP reading revealed 0.3% growth, in line with prior estimates and equaling second-quarter growth.

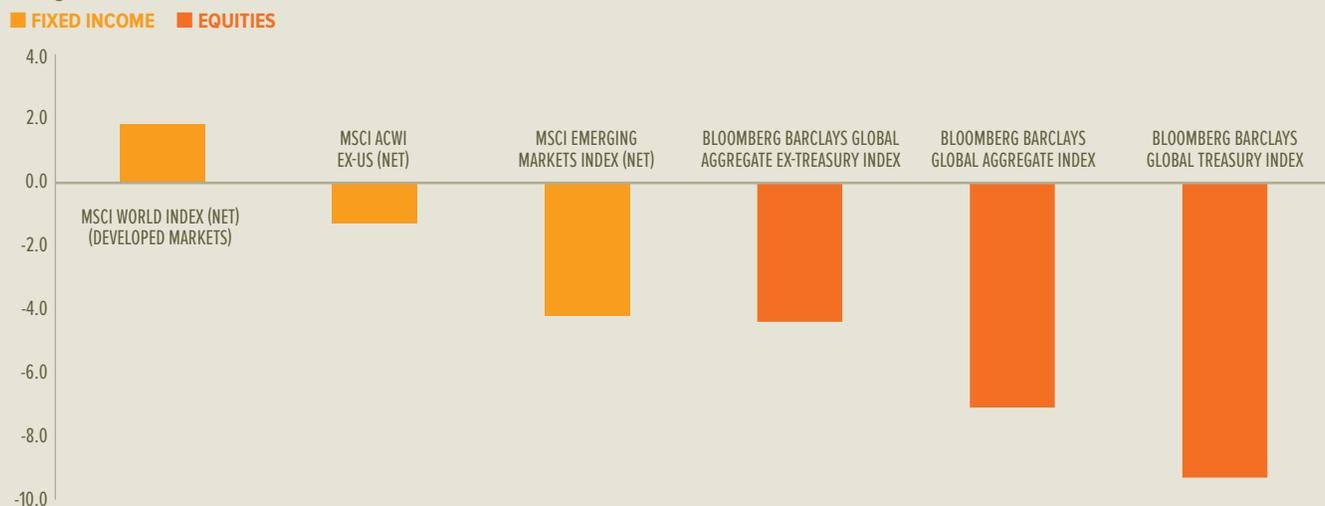
Portfolio Review

An overweight to financials was the top contributor in U.S. large-company equity performance during the quarter. The asset class also benefited from continued overweights to deeper-value and cyclical themes, which were boosted by Donald Trump's pro-business campaign victory. Security selection in technology and consumer discretionary detracted. The U.S. small-company equity market resumed its torrid pace as value sectors benefited from higher interest rates and energy prices. Positions in industrials and materials profited from these value tailwinds. An underweight to financials detracted as higher interest rates should help banks; stock selection in consumer discretionary was poor. Overseas, an underweight to real estate was positive as the sector struggled with rising rates and elevated valuations, and an overweight to energy contributed due to rising crude-oil prices. Underweights to materials and financials detracted as improved commodity prices and higher interest rates, respectively, hurt these sectors. Regionally, an underweight to Japan detracted while holdings in North America, particularly Canada, contributed. Within emerging markets, security selection was a key contributor in materials and consumer staples; however, it detracted in technology and industrials. A modest underweight to the Europe, Middle East and Asia region was positive overall; an overweight to Russia benefited from the rebound in oil prices, and an underweight to South Africa helped as the country continues to struggle with political uncertainty and a weak economy.

Core fixed income benefited from an overweight to banks; the sector outperformed as yields rose sharply after the election. Allocations to lower-rated securities and a shorter duration were also positive; however, a yield-curve-flattening bias detracted as long-term rates rose faster than short-term rates, allowing the yield curve to steepen. Overweights to commercial mortgage-backed securities and non-agency mortgage-backed securities (MBS) were additive thanks to the positive yield characteristics of the sectors; MBS was also supported by the housing market. The high-yield market was positive in 10 out of the 12 months in 2016, and had another solid quarter on the back of rising energy and commodity prices. At the sector level (and in what is a continuing trend), our off-benchmark exposure to collateralized loan obligations (CLOs) was the top contributor. Selection within basic industries and telecommunications (wireless) was additive, while selection detracted in retail and transportation. At the asset-class level, an allocation to bank loans outperformed, but a cash position underperformed. The U.S. presidential election caused shockwaves for emerging-market debt, especially local currency. Despite the struggles of local currency in general, we added value through security selection and by reducing a significant overweight to neutral before adding back to the position at more attractive levels. Conversely, an underweight to hard-currency bonds detracted as they outperformed local-currency debt. A position in Turkey contributed; we were able to quickly move from an overweight to an underweight as the country continues to deal with the effects of a failed coup earlier in the year, low net-currency reserves and a struggling economy. Despite underperformance from an overweight to Argentina, we still view the position as attractive and added to it during the quarter.

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Major Index Performance in Q4 2016 (Percent Return)

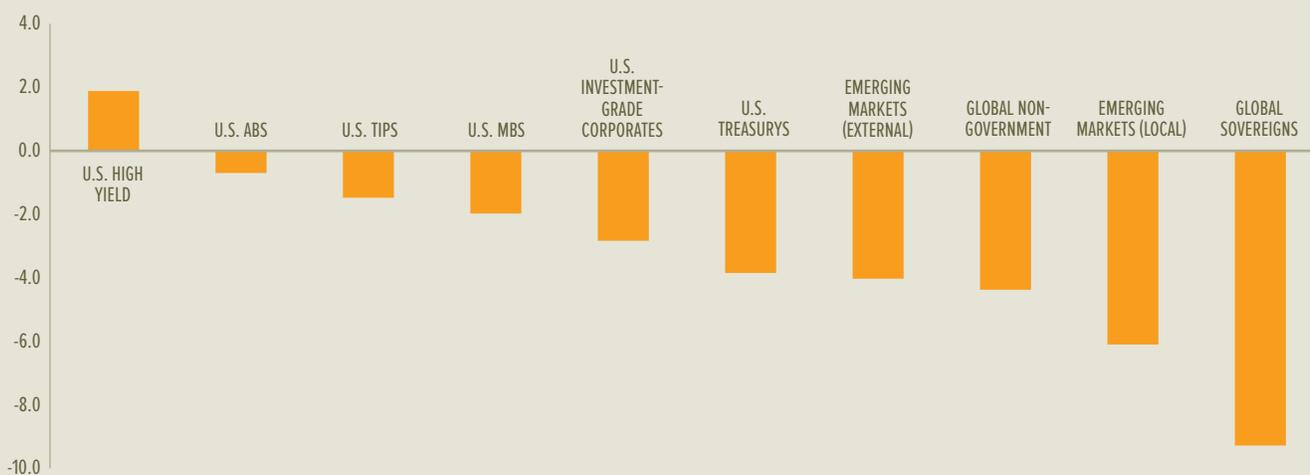


Manager Positioning and Opportunities

An overweight to technology in U.S. large-company equities remains. We prefer the risk-adjusted characteristics of this sector in a lower-growth economy, as it demands only modest capital-expenditure investment in order to improve efficiency gains and bottom lines. Meanwhile, we remain underweight consumer staples and momentum (which appears expensive) and overweight value. Within small-cap stocks, we cautiously favor stability-growth and deeper value; although these stocks have rallied sharply in recent months and valuations are stretched, we believe they still have some potential to outperform. Underweights to financials, real estate and consumer discretionary persist versus an overweight to industrials. Factor positioning remains consistent; we are underweight momentum as we believe it remains expensive, and overweight sustainable growth at this stage of the bull market. The technology theme carries over from U.S. large cap to international equities with a significant overweight in the sector. Real estate remains an underweight as the sector is expensive and may not react well to rising interest rates. An underweight to financials was also maintained; although rising interest rates should help margins, especially for banks, rates remain quite low. Within emerging markets, we retain exposure to consumers due to a positive long-term growth outlook. Sector positioning is somewhat similar to other regions with an underweight to financials and overweight to technology. Emerging Asia remains an underweight, particularly countries such as Korea and Taiwan, which have some exposure to China. Notably, India is modestly overweight as it exhibits favorable growth characteristics.

Core fixed income has retained an overweight to banking, but the positioning has recently been adjusted to favor U.S. banks over European banks which are facing significantly more headwinds. Within MBS, non-agency issues are preferred over agencies due to more attractive yield

Fixed-Income Performance in Q4 2016 (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 Q4 2016 (Percent Return)

■ COUNTRIES ■ REGIONS



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

profile, while the improvement in employment and incomes should support housing. A slight underweight to duration remains as the Fed has indicated its preference for higher rates. Lower-rated BBB corporates are favored over AAA rated securities due to higher yields. A yield-curve-flattening position remains thanks to a historically steep yield curve, low inflation expectations (although expectations have risen some, post-election), slow global growth and strong demand for liquid assets with positive yields supporting longer-dated U.S. Treasuries. Within high yield, our largest active position is an off-benchmark overweight to CLOs; we continue to see value in these on an absolute basis, but also relative to high-yield bonds. We are also underweight basic industry and capital goods due to a fragile global-growth environment, elevated leverage levels and weak commodity prices. We also maintain an underweight to energy due to caution over oil prices and supplies. We maintained a slightly more defensive posture via bank loans and cash. We are underweight BB rated credit and overweight CCC rated credit on the belief that the latter offers better total-return opportunities. Although an overweight to local-currency emerging-market debt was reduced during the quarter, we added back to the position in December as local-currency debt is now more attractive from a valuation standpoint. An overweight to corporate debt remains, offsetting some of the underweight to hard-currency debt. Our largest emerging-market debt overweight is to Indonesia, an outlier in its region that has been resilient in the face of China's weakness. We are also overweight Brazil and Argentina. Our largest underweight is to China, where positioning is driven by a currency short and avoidance of quasi-government debt. We are also underweight Singapore. We expect weak data from China to continue weighing down emerging-market debt, especially surrounding emerging Asia and China's trading partners. In addition, if more U.S. interest-rate hikes come to fruition, the asset class may underperform — especially local-currency debt, due to the resulting stronger U.S. dollar.

Our View

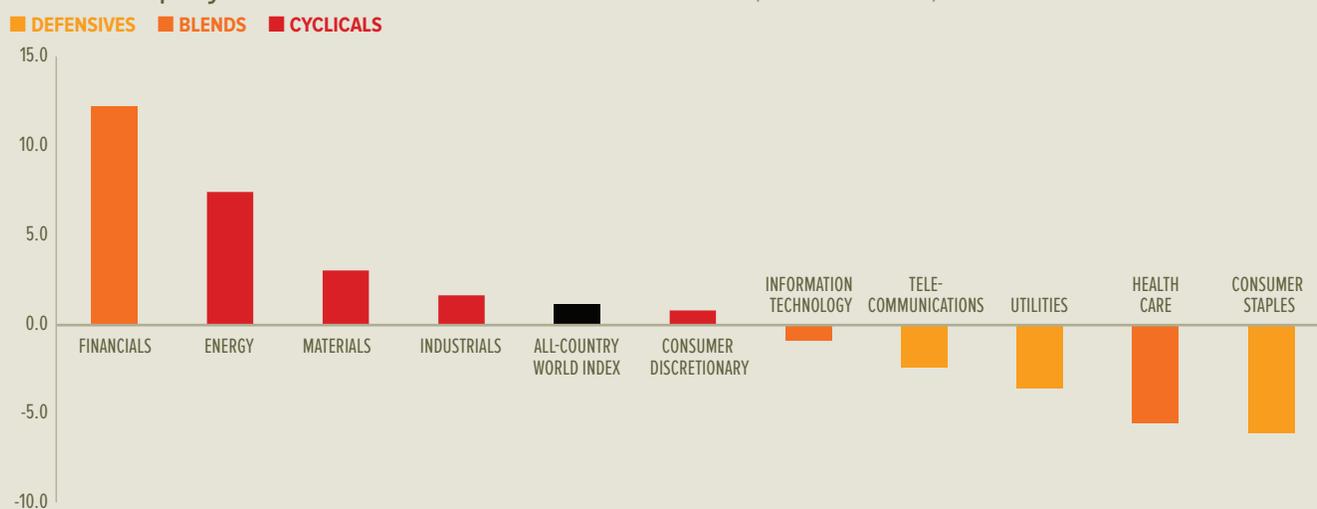
Change is coming in many aspects of U.S. policy — economic, social and diplomatic. We expect the new president to drive a great deal of activity in the months ahead that aims to break down disincentives to hiring, bank lending, new-business formation and investment. Investors are betting that the shake-up in Washington will lead to higher growth and profitability — as well as higher inflation. We suspect this reaction is, more or less, the right one. Nonetheless, since there are still more questions than answers regarding the details, investors need to be prepared for a more volatile ride as 2017 unfolds.

So what do we think we know about future economic policy? Some of it (tax and regulatory reform) should be positive and increases our optimism that economic growth will accelerate. Taxes and regulations top the list of problems facing small businesses, the traditional primary job creators. 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.

Some other policy expectations (up-ending 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. The biggest impediment to a favorable investment environment 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.

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. Surprisingly, commodity prices have been rather resilient since the U.S. elections. We

Global Equity Sector Performance in Q4 2016 (Percent Return)



Sources: FactSet, Lipper. MSCI All-Country Sector Components (as defined by SEI).

wonder how long this will be the case, if the dollar maintains its upward trajectory as we expect. If the Federal Open Market Committee forecast 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.

The winds of political change are blowing through Europe too. Italy's referendum on December 4 already led to the resignation of Prime Minister Matteo Renzi. Establishment parties are now working to change the rules of the game to make sure Beppe Grillo's Five Star Movement fails to gain the seats necessary to form a government when the next election comes.

General elections will be held in the Netherlands, France and Germany this year. Of these three, we judge the French presidential elections to have the greatest importance for investors. The first round will be held April 23, with the final round scheduled for May 7. It looks likely that voters will select from 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. 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 but has the potential to be positive for the French economy and financial assets, or they take a gamble on economic nationalism that could lead to the unravelling of the euro-currency framework.

While political considerations remain a source of angst in Europe, economic growth actually has been surprising observers to the upside lately. 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 the start of formal negotiations with the European Union (EU). 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.

Negotiations don't formally begin until Article 50 is invoked at the end of March, and investor attitudes could again turn cautionary in the months ahead. Besides, the other 27 member countries of the EU may want 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.

Emerging markets had a seriously negative reaction to the Trump election. Concerns about the new administration's stance on trade and resumption of the dollar's appreciation are the main factors for the setback. 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, but the maintenance of open markets and strong trading relationships are crucial too. The aggressive approach toward trade issues likely to be adopted by the Trump administration leaves investors with an uncertain outlook.

Investors are betting that the shake-up in Washington will lead to higher growth and profitability — as well as higher inflation.

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. 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 a sharp turnaround in energy-sector profitability push year-on-year earnings growth higher.

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 one to ten 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 is an unmanaged market-capitalization-weighted benchmark that 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. Treasuries.

The BofA Merrill Lynch U.S. High Yield Constrained Index contains all securities in The BofA Merrill Lynch US High Yield Index but caps exposure to individual issuers at 2%. The BofA Merrill Lynch US 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 98-99% 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 All Country World Index is a market-capitalization-weighted index composed of over 2,000 companies, and is representative of the market structure of 46 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 All Country World ex-US 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 designed to measure the equity market performance of countries within EMU. The MSCI EMU Index consists of the following 10 developed-market country indexes: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal and Spain.

The 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 World Index is a free float-adjusted market-capitalization weighted index designed to measure the equity market performance of developed markets. The MSCI World 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 United Kingdom, and the United States.

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

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