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Point of View

Economic Review and Outlook

The Outlook: A Year of Big Changes Ahead

The good news

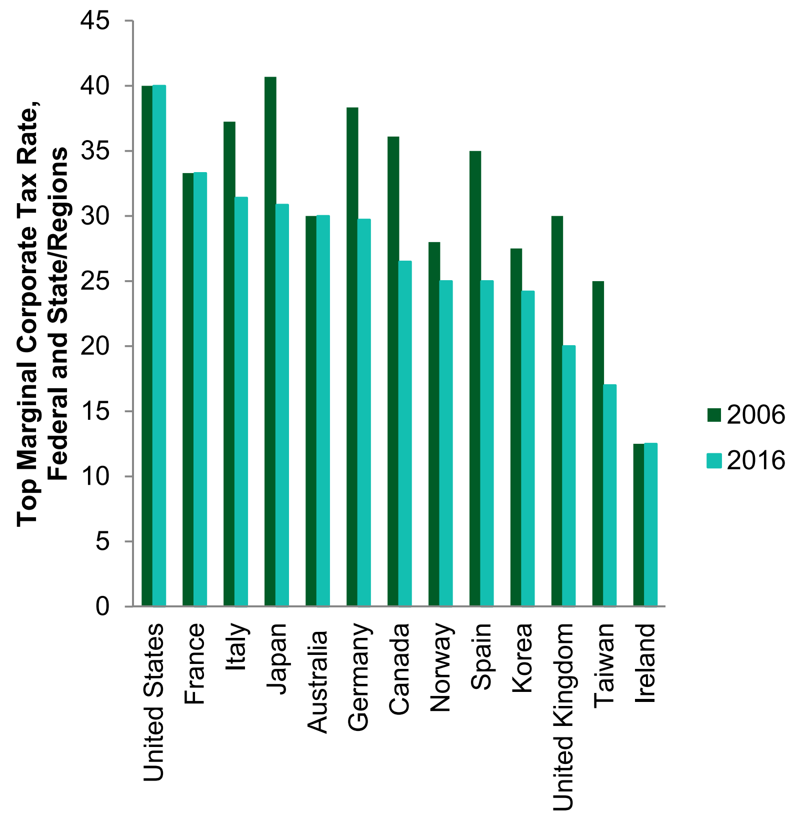
- Investors perceive that the election of Donald Trump, the maintenance of Republican majorities in the House and Senate, and overwhelming Republican representation at the state level will pave the way for dramatic changes in U.S. economic policies.
- Tax reform, both corporate and individual, is high on the agenda. We expect a boost to after-tax earnings, cash flow and incomes. Major regulatory reform also will likely proceed, with the aim of reducing the cost of doing business and increasing incentives to hire.
- European economic activity has improved in recent months despite the potentially disruptive impact of Brexit and rising political uncertainty.
- The world appears to be enjoying a synchronized economic expansion for the first time since 2009-10. Fears of a sustained deflation in Europe and Japan are finally fading.

The bad news

- The Trump Administration's shift to a more combative stance on trade, especially if the focus returns toward China, could rattle investor confidence.
- Fiscal stimulus at a time when the unemployment rate is already well below 5% could lead to a faster-than-expected acceleration in inflation and force the Fed to tighten policy more aggressively.
- Populist politics will continue to be a concern in Europe. Elections in France this spring could prove pivotal for European markets and the euro.
- The economic disruption posed by Brexit should come into better focus in 2017 as negotiations begin in earnest.
- High debt burdens continue to stress many countries, especially in the European periphery. China's financial situation, however, remains out greatest source of concern.

Deep in the heart of taxes

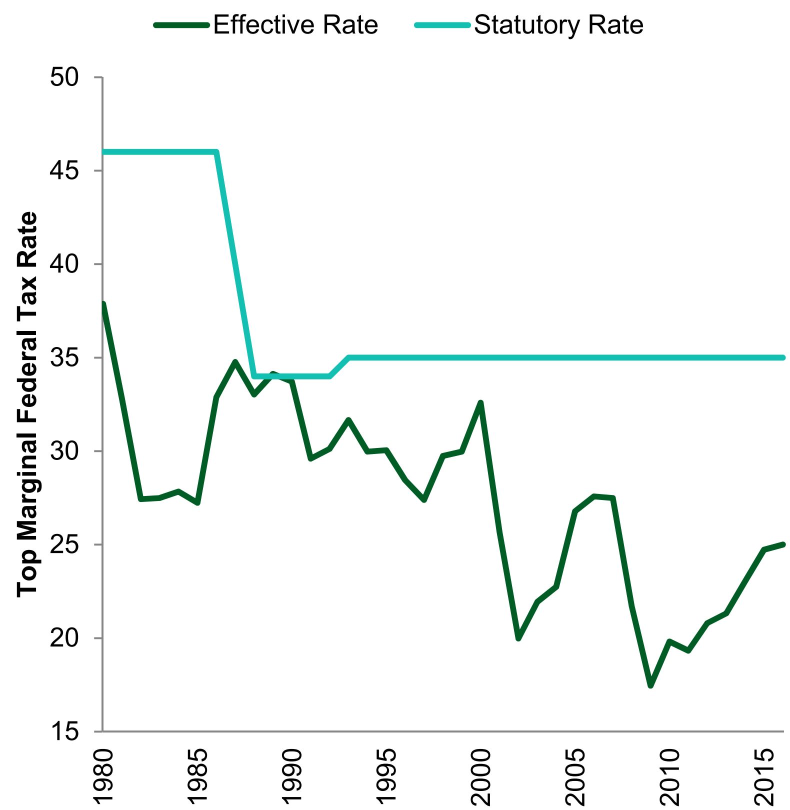
- U.S. corporate marginal tax rates are set to decline.
- The incoming Trump administration has suggested a 15% top statutory rate versus the current 35%.
- That would take the U.S. from the highest statutory rate among developed countries to almost the lowest.
- As the chart illustrates, the representative 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.



Source: KPMG, SEI

It will be hard to close this gap

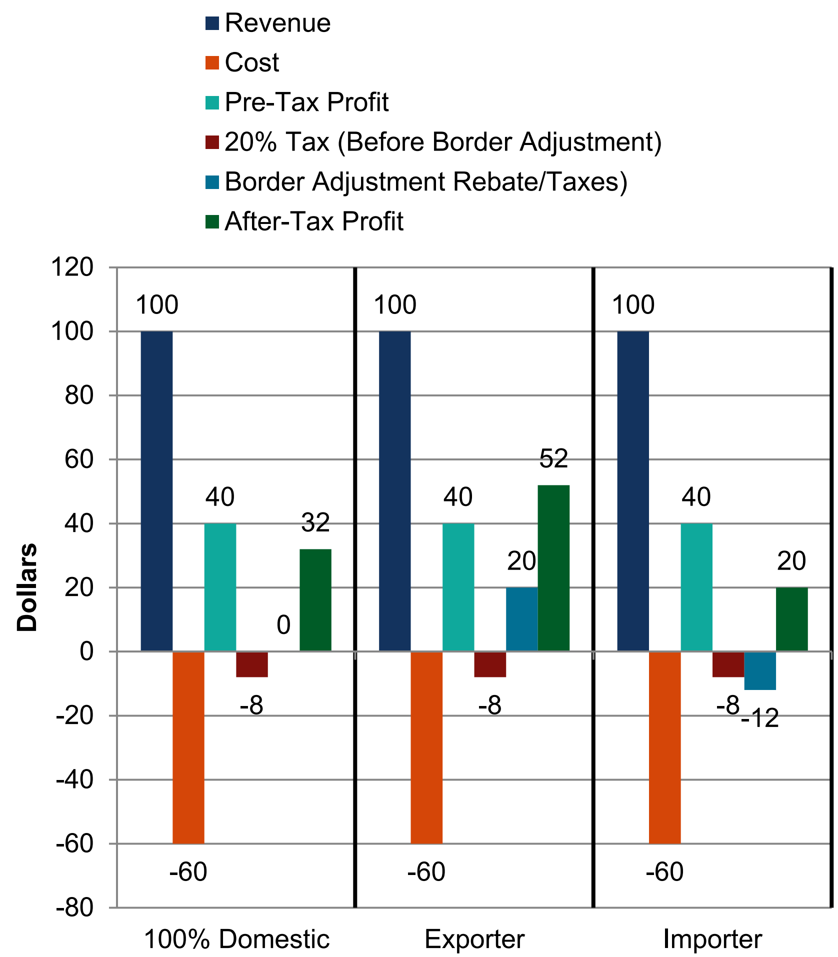
- The chart highlights the yawning differential between the U.S. federal statutory tax rate (reflecting the tax rate set by law) and the effective rate (which reflects what corporations actually pay).
- Currently, corporations pay an effective tax rate of about 25%; domestically oriented, service-producing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



Source: Oxford Economics, Tax Policy Center, SEI

Going to BAT

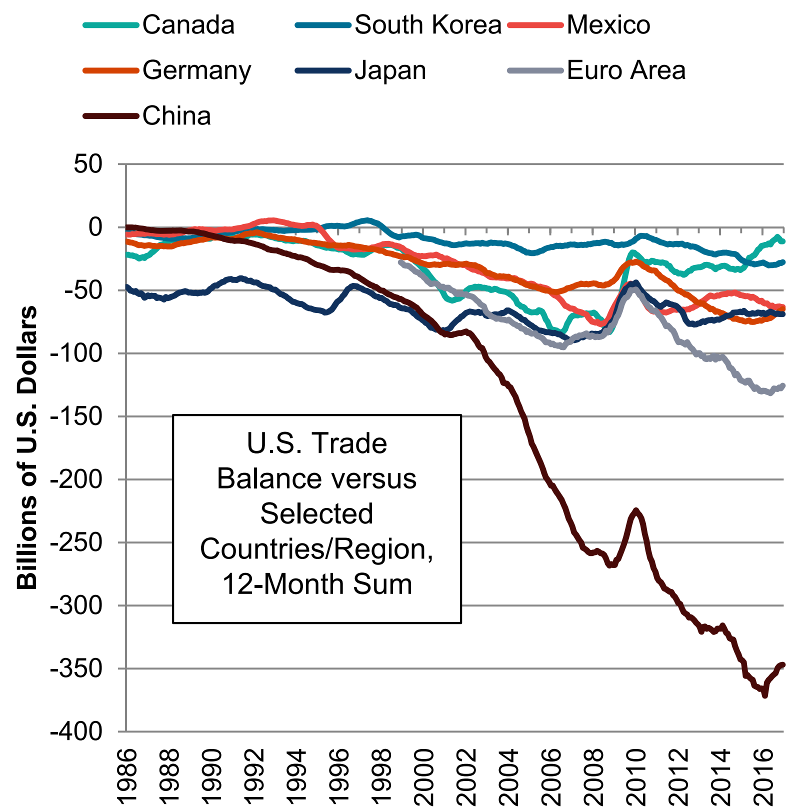
- One of the biggest challenges facing Congress is how to pay for lower tax rates.
- A border adjustment tax (BAT) that taxes the value added of imports and rebates the value added of exports is being championed by the House leadership.
- Unless the dollar appreciates by some 25%, a 20% will lead to major distributional affects favoring exporters at the expense of importers.
- Since the U.S. runs a $500 billion trade deficit in goods and services, a 20% BAT could theoretically raise $100 billion per annum in tax revenues.
- A BAT is not compliant with WTO rules, but is conceptually closer to a value-added tax (VAT) than the current U.S. corporate tax regime.



Source: BCA Research, SEI

Where Trump sees red

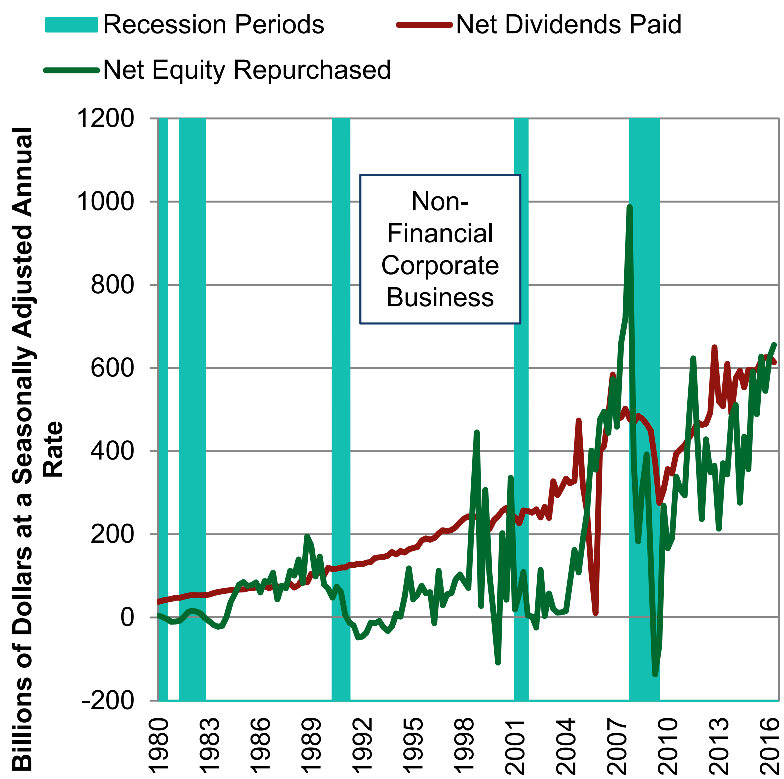
- Trade has been a flash point for the new Administration.
- Mexico has been the primary focus, although Germany and Japan run surpluses against the U.S. that are equally large.
- Surprisingly, President Trump has been circumspect about China, despite the fact that it accounts for almost half of the U.S. merchandise trade deficit.
- We remain concerned that China will be designated as a currency manipulator, although it's hard to say what this will mean in practice.
- A tit-for-tat trade war, combined with geopolitical tensions over China's island-building, could derail an otherwise promising macroeconomic environment.



Source: U.S. Census Bureau, SEI

Stock buybacks are still popular

- A “tax holiday” on repatriated funds will likely bump up shareholder payouts via dividend increases and share buybacks.
- During the 2004-2006 repatriation tax holiday, stock repurchases took off in an unprecedented fashion as 843 companies brought back a total of $362 billion – amounting to 15% of the total cash currently held in foreign jurisdictions by S&P 500 companies.
- Looking at the S&P 500, dividends per share grew at a 12% annual rate between 2004 and 2006, while EPS accelerated to 23% in 2004 and grew an additional 15% in 2005 and 14% in 2006.
- Today, we see little evidence that stock buybacks or dividend payments are going out of style; although limits on interest deductions and the BAT may change that calculus for some companies.

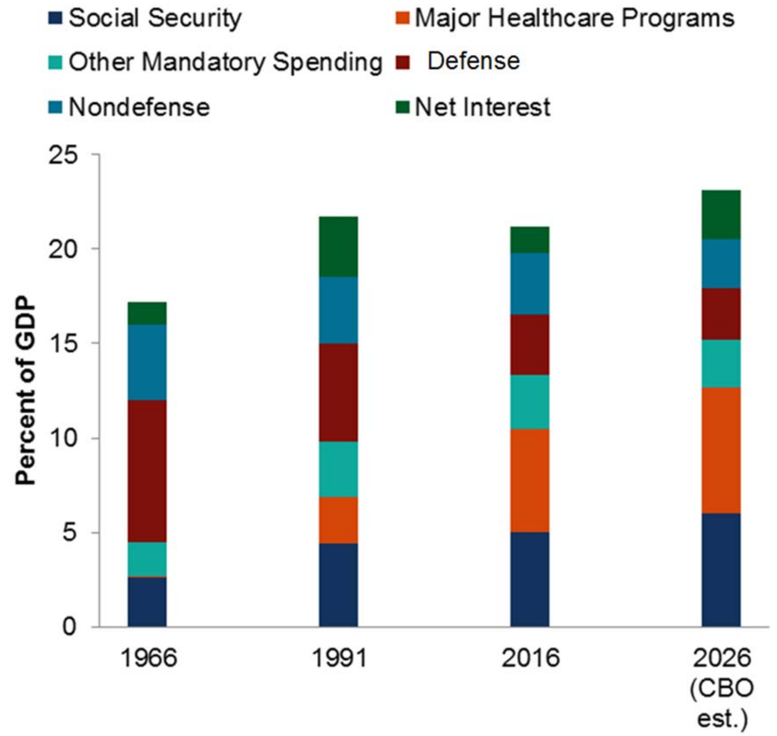


Source: Economic Cycle Research Institute, Federal Reserve Board, SEI

Mandatory reading

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

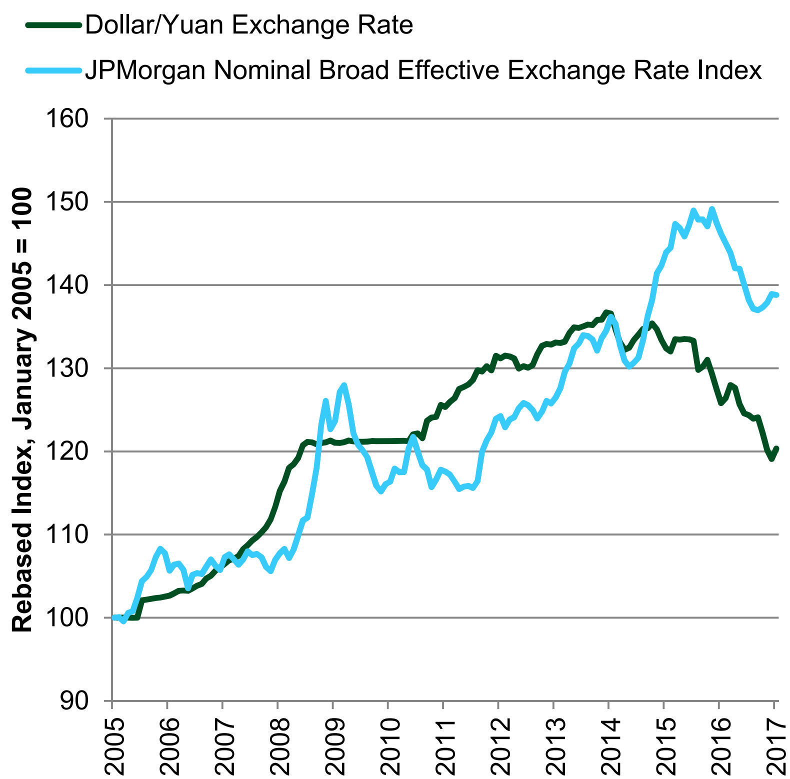
Federal Government Outlays as a Percent of GDP



Source: Congressional Budget Office, SEI

Yuan a piece of me?

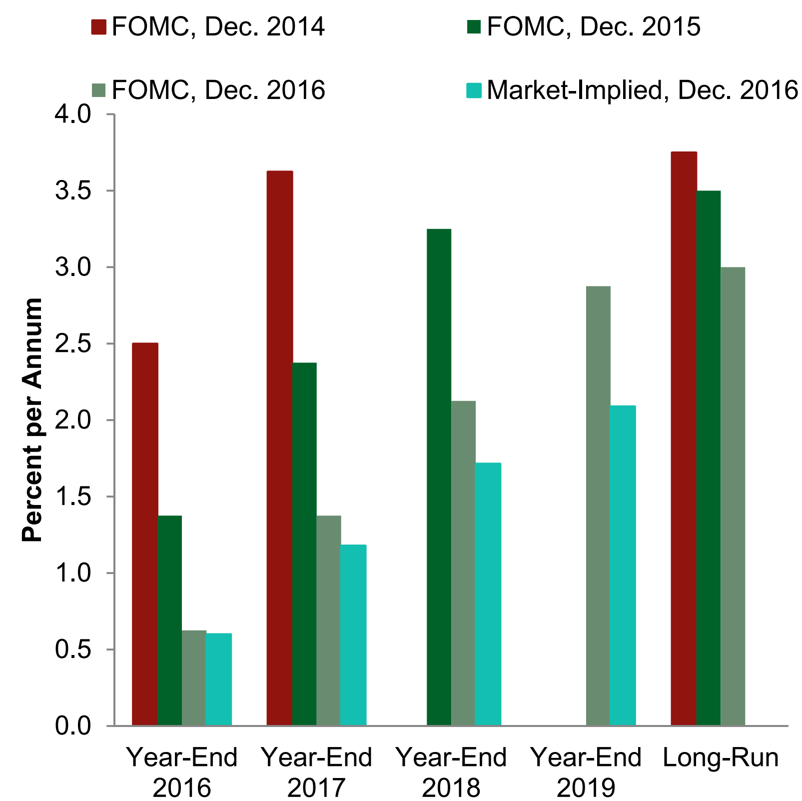
- There is no certainty when it comes to the tactics President-elect Trump will employ to attain a “better deal” on trade.
- That noted, the odds of a confrontation with China seem uncomfortably high to us. So far, the Trump Administration has bided its time, refraining from declaring China a currency manipulator.
- The accelerating decline in China’s currency against the dollar to its lowest level in more than eight years will not help matters.
- 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.



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

They will be right some day

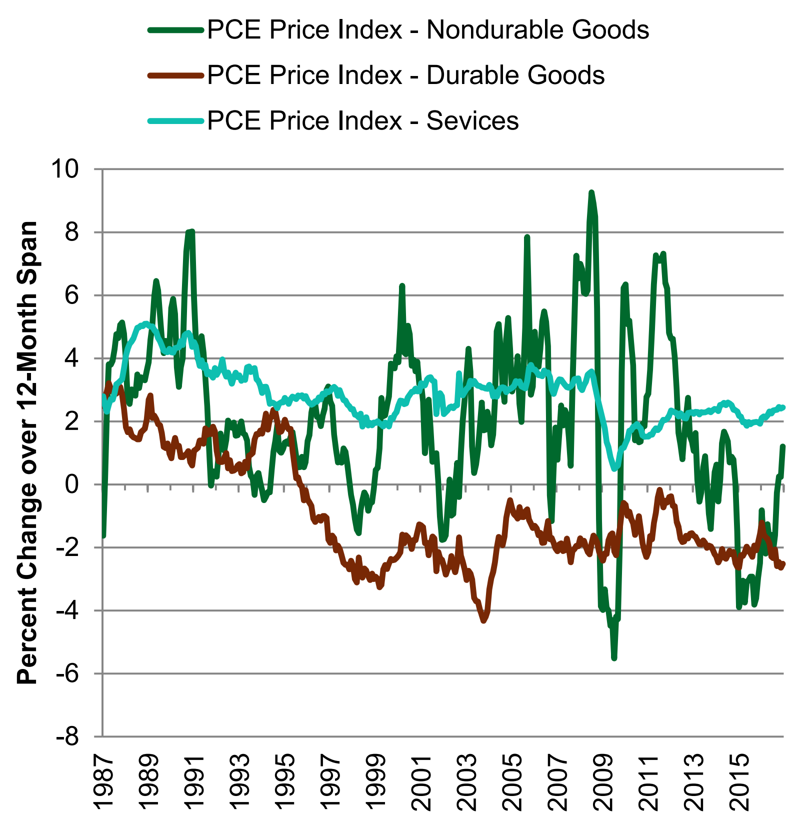
- The Federal Open Market Committee (FOMC) increased its number of projected rate hikes for 2017 from two to three.
- The median FOMC forecast of the funds rate by the end of 2017 is now 1.4%.
- This action should be kept in perspective. As the chart illustrates, the Fed governors and regional presidents 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%.



Source: Federal Reserve Board, SEI

Inflation in services, deflation in goods

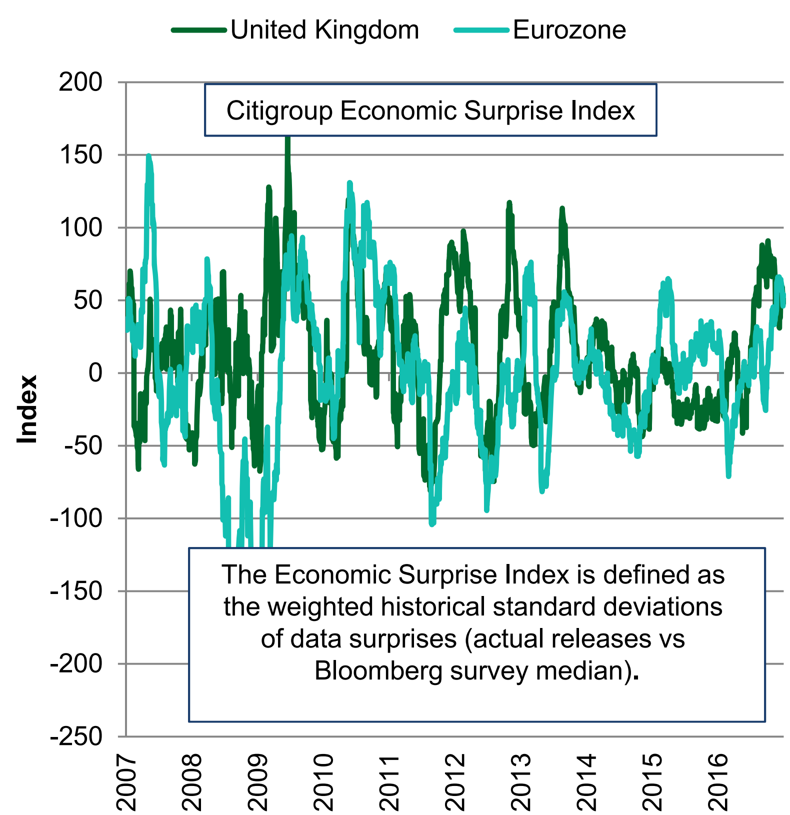
- Using the Fed's preferred inflation yardstick — the personal consumption expenditures price index (PCE Price Index) — inflation in services has accelerated in recent months.
- Deflation remains a feature of goods prices, however, especially for durable items. The dollar's strength is an important factor 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 and blame NAFTA because the deflation trend began to take hold in 1995, the year NAFTA took effect.



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

Pleasant surprises (for now)

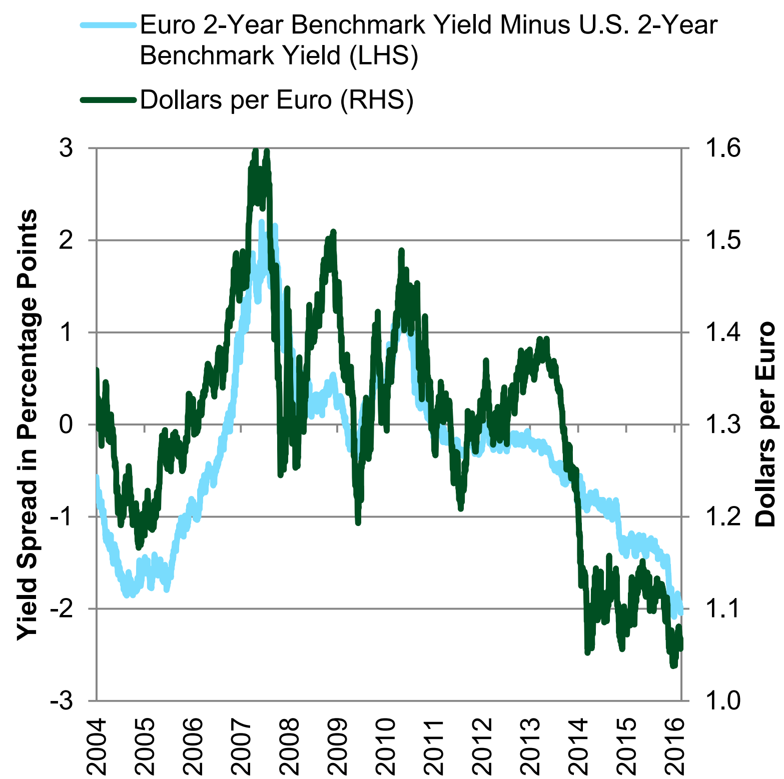
- While political considerations remain a source of angst in Europe, economic growth actually has surprised observers to the upside lately. Citigroup's Economic Surprise Index (which measures the extent of surprise caused by data releases, based on the reaction of the currency market) has improved sharply 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.



Source: Citigroup, SEI

As spreads widen, the euro gets squeezed

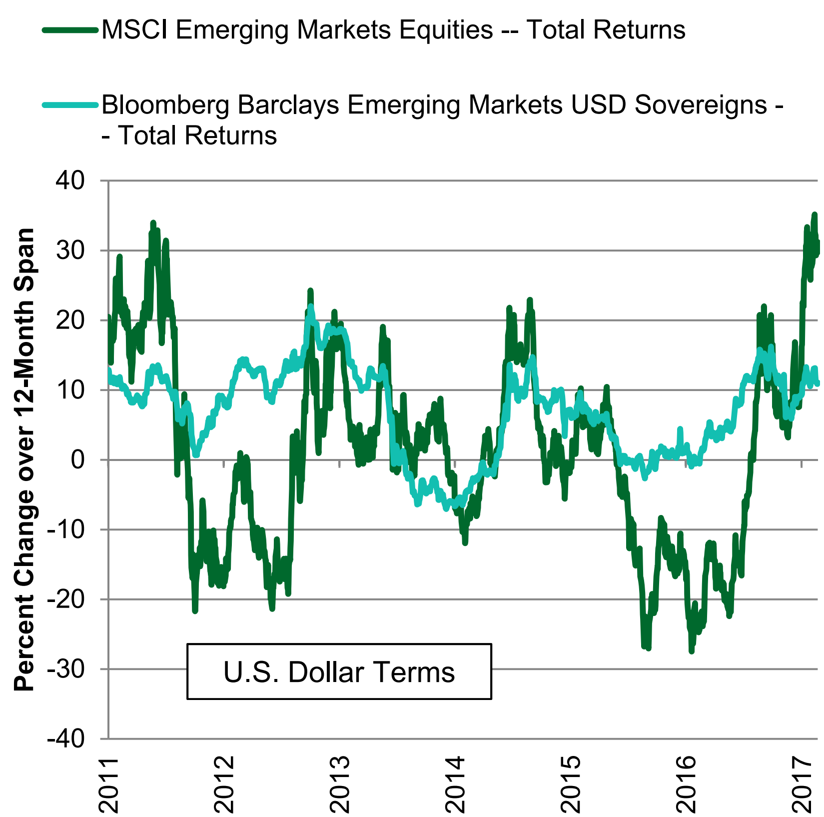
- The European Central Bank's decision to extend asset purchases through the end of 2017 (albeit at a somewhat reduced pace) emphasizes the divergent paths of monetary policy in Europe versus the U.S.
- Interest-rate differentials have widened meaningfully between U.S. Treasury and eurozone benchmark 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.



Source: Tullet/Prebon Information, WM/Reuters, FactSet, SEI

Emerging markets re-emerged in 2016

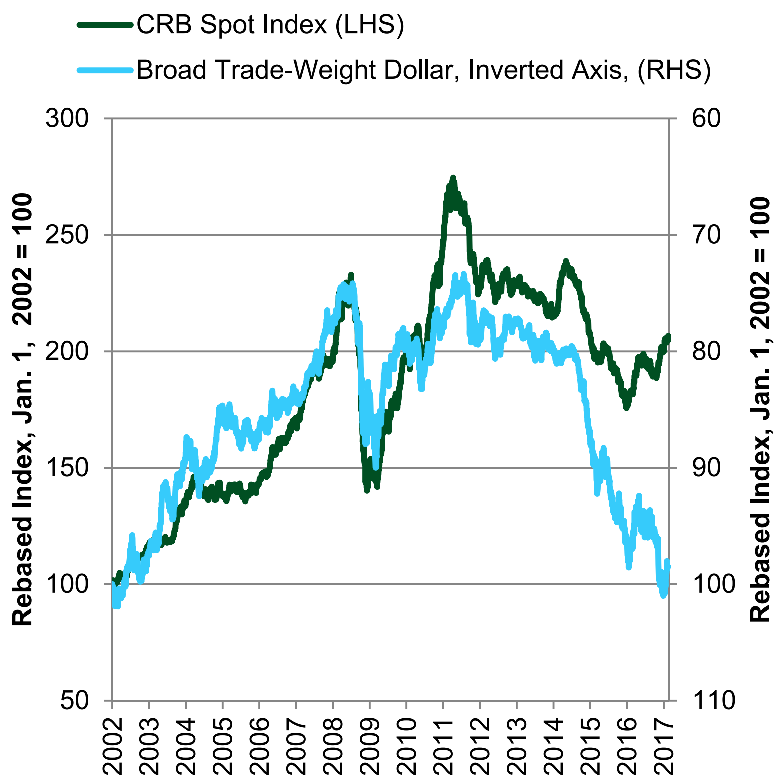
- Emerging markets had a seriously negative reaction to the Trump election.
- Despite the decline, equity and fixed-income asset classes both recorded respective gains of 11.67% and 9.2% in U.S. dollar-terms for 2016; although year-over-year increases reached 16% for bonds and over 20% for stocks as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



Source: Bloomberg Barclays, MSCI, SEI

Commodity prices climb in defiance of the dollar

- The chart 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.



Source: Commodity Research Bureau, Federal Reserve, SEI