

First Quarter 2012: Economic Outlook

The Rally at Six Months: Riding the Wave, But Watching Out for Shocks

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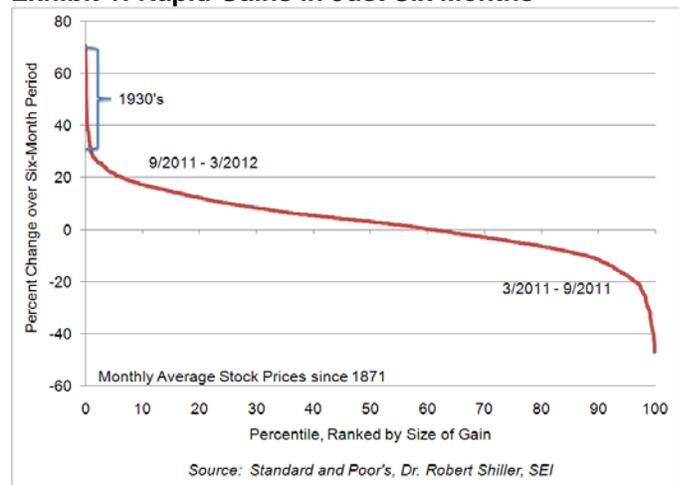
It has been a terrific run, with equity markets around the world recording a price gain of close to 20% over the past six months and the S&P 500 advancing more than 28% from its closing low on October 3. As is often the case, this breathtaking move to the upside had its genesis in a period of deep investor gloom. Back in late September and early October, there were many things spooking the financial markets: fears of recession in the U.S., the European debt crisis and the possibility of a hard landing for the Chinese economy, to name a few.

The question now is, “What comes next?” The economic and financial backdrop certainly has improved since the dark days of last autumn, but one can make the argument that the rally already reflects this improvement. Besides, new challenges are coming into view that will test investors and the resiliency of riskier assets in the months to come. In our opinion, the surge in stock prices has brought valuations back in line with the fundamentals. Instead of taking a contrarian stand as we did six months ago, we are more inclined to “go with the flow,” maintaining a pro-cyclical investment stance until valuations become more worrisome, or the economic trends start to point toward another period of uncertainty and volatility. We will detail in this report some of the factors that investors should monitor as the rest of the year unfolds.

We've Come a Long Way

There is no question that the gains of the past six months have been unusually large. Exhibit 1 shows the rolling six-month price returns of U.S. large-cap stocks since 1871. We ranked the returns from the highest six-month return to the lowest, lumping the results into percentiles. You can see that the past year has witnessed an extraordinary swing in performance. Between March 2011 and September 2011, the S&P 500 recorded a price decline of 10% (using monthly averages), putting the result in the 88th percentile. Over the past six months, by contrast, monthly average stock prices have advanced 18.3%. That gain ranks in the 8th percentile of performance for all six-month periods over the past 141 years.

Exhibit 1: Rapid Gains in Just Six Months



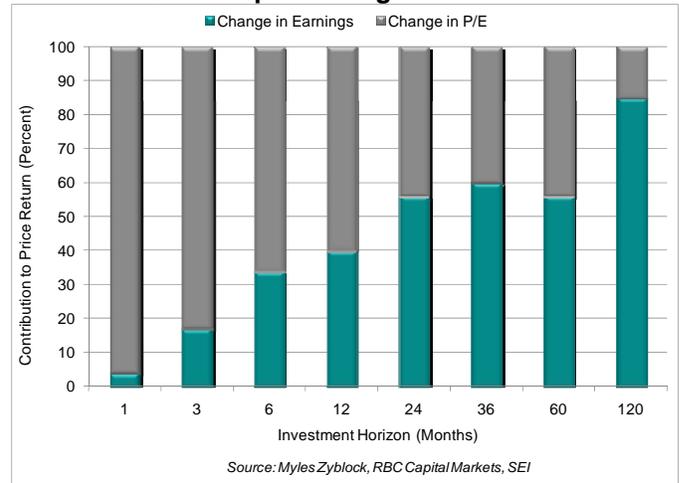
Interestingly, the fact that prices have risen rapidly in a relatively short period is not a bearish indication by itself. On average, stocks have recorded an additional 10% price gain during the 12 months following a six-month jump in the S&P 500 of 15% or better. That compares against a 5.8% 12-month price gain over all periods since 1871. The standard deviation of the returns following a strong six-month period (16%) is also less than for the full historical period (19%).

Obviously, we must take other factors into account in order to determine whether momentum or a return to the mean is the more powerful force. Although stocks, on average, have continued to perform well after a strong six-month gain (i.e., a momentum strategy worked), stock prices also have fallen in the following 12 months about a quarter of the time. Fundamentals, valuation and technical factors need to be considered.

In our view, valuation itself is not a very good predictor of short-term market moves. Last year's up-and-down performance was a case in point. When prices peaked in the May 2011 to July 2011 period, valuations were not terribly extended, yet stock prices fell sharply as investors priced in the prospects of recession and a profits downturn. As recession worries ebbed, stocks rebounded even as analysts' forecasts of profit growth were steadily reduced.

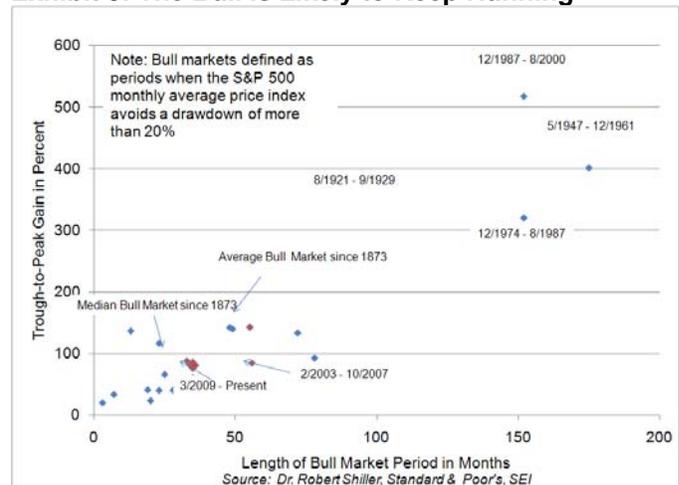
Exhibit 2 underscores the futility of trying to align near-term equity performance with earnings. According to work done by Myles Zyblock, Chief Institutional Strategist at RBC Dominion Securities, only 40% of the equity market's price return in any given year is directly attributable to the change in earnings. The majority of the impact comes from the fluctuations in price/earnings ratios. Even over a span of two to five years, the change in earnings accounts for only 55% to 60% of the change in stock prices. One needs to have a 10-year time horizon to have the change in earnings account for 85% of the contribution to price return. We would note that even 10 years would be inadequate, if your starting point is a period of very high valuation, such as the tech boom of 1999-2000, or very low valuation, as in 1982. Since 2000, for example, stock prices are still below their peak levels, even though the S&P 500 companies' operating earnings have more than doubled.

Exhibit 2: P/E Trumps Earnings



To be clear, we are not saying that profits or valuations do not matter. We merely want to point out that investors' expectations and their reaction to surprising events have been much stronger drivers of stock prices than the direction of earnings over the past year or more. Even after the recovery in equities to new cycle highs for the S&P 500, price-to-earnings ratios appear reasonably attractive, with the multiple on expected earnings over the coming year hovering around 12.8—one point below the long-term average. Consequently, SEI believes the odds favor an extension of the cyclical bull run in equities—the likely possibility of a mid-year pullback or consolidation notwithstanding. As noted in Exhibit 3, the three-year-old bull market has already achieved the gains that are typical, in both magnitude and longevity, of the median bull market. The current bull market, though, still pales against the multi-year gains seen in the 1920s or during the latter half of the 20th century. The bottom line: This is no baby bull, but there is no reason to think that it will die of old age anytime soon.

Exhibit 3: The Bull Is Likely to Keep Running

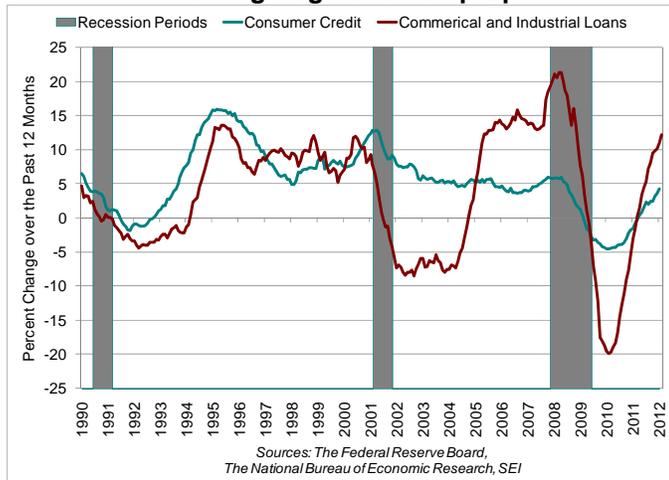


Putting the Fun Back into Fundamentals

Last year, those with a bearish view argued that a combination of surging oil prices, the European debt crisis and policy gridlock in Washington would lead to a double-dip recession in the U.S. The outcome has been quite the opposite. U.S. economic activity and credit growth continue to improve as conditions in the banking system work their way back to normal. The recent stress test conducted by the Federal Reserve (Fed), which featured a 13% unemployment rate, a 50% decline in stock prices and a 21% drop in housing prices, showed that the most systemically important banks have achieved fortress-like balance sheets, enabling them to re-establish or hike dividend payments and engage in stock buybacks. Even the few institutions that failed the stress test need only to revise their use of capital, as opposed to contracting their balance sheets or diluting shareholders by raising additional capital.

Exhibit 4 tracks the 12-month change in consumer credit and commercial and industrial loans. Business loans suffered a huge contraction during the recession, but they have now rebounded to a double-digit gain. Consumer credit, meanwhile, has begun to expand again on a year-over-year basis. The advance has been driven mainly by non-revolving debt (student and auto loans), but credit card debt also has started to advance since the middle of last year. As we have noted in previous reports, the deleveraging of households and the banking system has been more dramatic in the U.S. than in other advanced countries. The credit-creation machine is starting to operate once again.

Exhibit 4: Borrowing Begins to Ramp Up

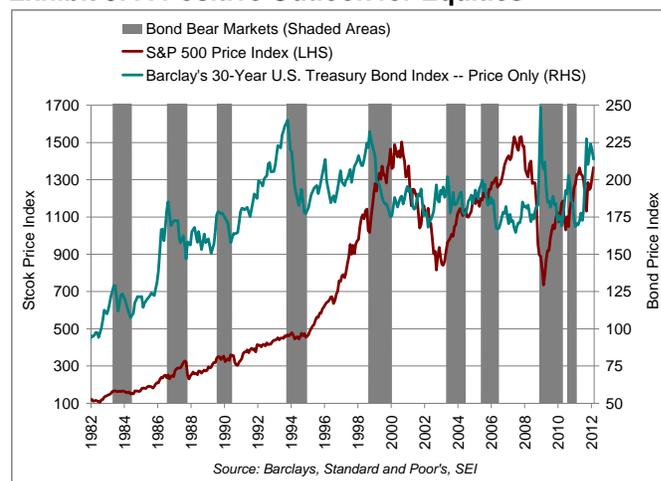


Investors Begin to Jump Off the Bondwagon

Three months ago, we highlighted the rapid improvement in the economic data and pointed out that this surprising strength was not impressing fixed-income investors. We speculated that, in a more normal economic cycle, the yield on 10-year Treasury bonds would be closer to 3% than 2%. Perhaps the bond vigilantes are beginning to wake up, selling their holdings and driving up yields in protest of the government's easy monetary policy. In just a few short sessions in the latter half of March, Treasury bond yields experienced their sharpest advance since October, as prices fell.

What would a new bear market in bonds mean for equities? A review of the past 30 years suggests that the stock market is more likely to appreciate than decline during an extended period of bond price weakness. Exhibit 5 plots the end-of-month S&P 500 price index against the Barclay's 30-Year U.S. Treasury bond price-only index. The shaded areas indicate the periods of significant bond-price declines. In many bond bear markets—1986-87, 1998-99, 2003-04, 2005-06, 2009-10 and 2010-11—stock prices moved higher. Especially when yields are rising from particularly low levels, the odds favor rising equity prices.

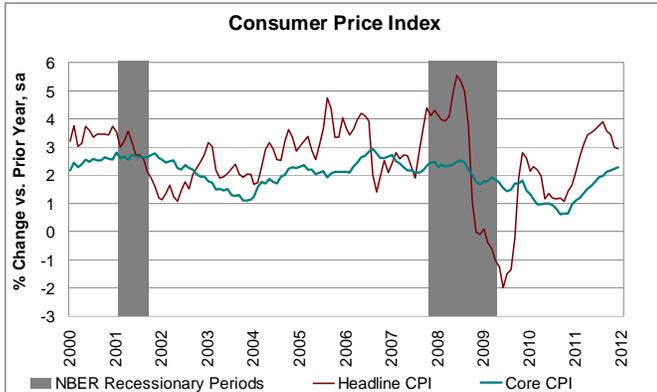
Exhibit 5: A Positive Outlook for Equities



Another aspect of a stronger economic expansion, though, is a higher inflation rate. Bond yields around 2% are not terribly attractive, even in a time of price stability. In recent years, real yields have turned increasingly negative owing to a rising inflation rate.

Over the most recent 12 months, the overall inflation rate amounts to nearly 3%, as seen in Exhibit 6. Excluding energy and food, the ride has been a bit smoother, with core inflation generally fluctuating in a range of 1% to 3%. Currently, the core Consumer Price Index (CPI) measure is running at a rate of 2.2%, slightly above the Fed's announced inflation target (note that the Fed actually uses the core Personal Consumption Deflator, which remains just under the 2% target).

Exhibit 6: Rising Inflation



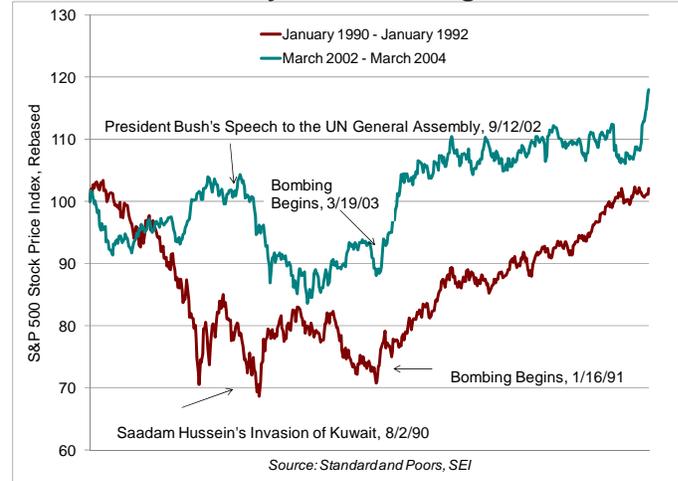
The consensus view of economists calls for a rapid moderation in headline CPI inflation from the current 3% rate to 2% by the middle of the year. It is expected to stay at that 2% level through the rest of this year and for all of 2013. In SEI's opinion, this forecast seems rather optimistic.

The influence of oil prices is one of our chief short-term concerns. Brent crude oil is currently trading around \$125 per barrel, which is closing in on the previous peak recorded last year (\$147 per barrel) and up 15% year to date. You may recall that the civil war in Libya was heating up at this time last year, raising fears that oil supplies would be cut drastically. In 2012, geopolitical fears are taking center stage yet again, as the Western democracies attempt to rein in Iran's nuclear ambitions. In the worst-case scenario, Israel could attack Iran's nuclear sites. This would undoubtedly cause a temporary spike in energy prices that would conceivably push Brent oil above \$200 per barrel, even in the absence of any prolonged disruption in oil supplies.

Clearly, military action against Iran is a black swan event that would have a severe impact on the global economy and on financial markets. While SEI is closely monitoring geopolitical events, we do not anticipate taking dramatic investment action. Commodity prices have a tendency to mean-revert—what goes up usually comes back down.

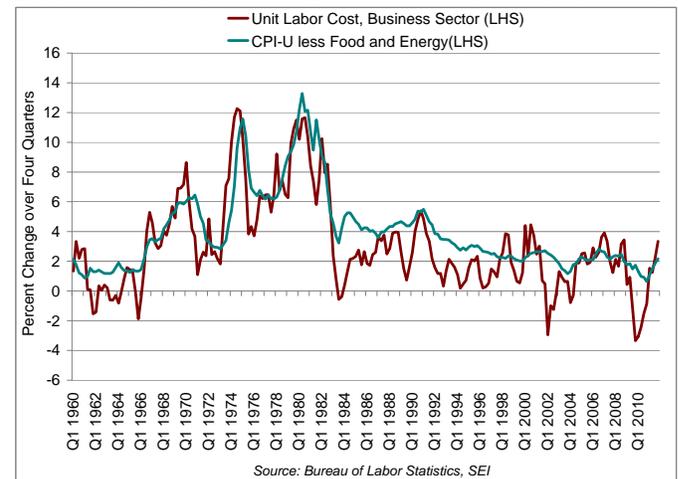
Looking beyond oil prices to the broader financial markets, stock prices tend to sag in the run-up to military conflict, but then rally sharply as war becomes reality. This was the case in January 1991 and in March 2003. Equities were roughly 20% higher six months after the two invasions of Iraq, as seen in Exhibit 7.

Exhibit 7: Stock Rally When War Begins



More concerning for the long-term inflation outlook would be a rise in labor costs without an accompanying gain in productivity. The four-quarter change in business-sector-unit labor costs shows that the subpar employment recovery from the 2008 downturn kept wage growth under wraps through 2010, despite exceptionally strong productivity. However, there are signs that upturns in employment and wages have gained some traction. Unit labor costs posted a 3.3% gain in 2011, well above the 3% decline recorded in 2009. Exhibit 8 shows that changes in the core CPI and in unit labor costs tend to be closely correlated.

Exhibit 8: Inflation and Labor Costs Move in Tandem



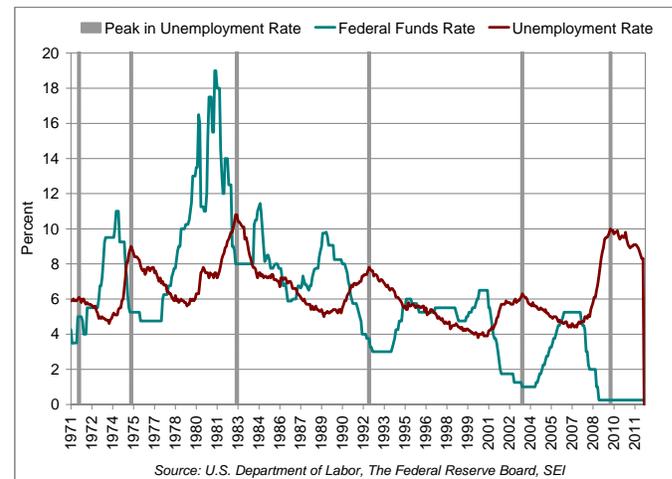
We believe the U.S. labor market has turned the corner and will continue to strengthen. On the bright side, this provides for a self-sustaining economic expansion as rising employment and wages create the wherewithal for higher spending. On the downside, core inflation will likely move higher over time, especially if the Fed and other major central banks keep interest rates extremely low. Granted, core inflation tends to be sticky. It has not been above 4% in the U.S. since the early 1990s. But we believe current economic policies, both here and abroad, are setting the groundwork for a higher inflation rate in the years ahead. Investors with longer time horizons should consider assets that offer inflation protection.

How Will the Fed Proceed?

The Ben Bernanke Fed has done a creditable job in navigating through some pretty tough times. It was aggressive when it had to be, quickly cutting the federal funds rate during the 2008 crisis and devising more creative solutions (two rounds of quantitative easing and an enhanced communication policy) once the funds rate hit the zero limit. During the past year, however, it has opened itself to criticism for maintaining an extraordinarily expansive monetary policy in the midst of economic recovery, albeit a recovery that has been rather tepid. Its latest policy maneuver, buying longer-term T-bonds in exchange for shorter-term paper, will be coming to an end in June. Although the Fed's Board of Governors and regional presidents are on record forecasting no change in the funds rate until late 2014, one has to question whether that forecast will need to be revised as the economy shifts onto a higher growth track.

Exhibit 9 features the unemployment rate and the federal funds rate. We highlight the peak in the unemployment rate with vertical lines. The funds rate usually hits its cyclical low around the same time as the peak in unemployment. It then holds steady for a year or two as the unemployment rate declines past 7%. During the current cycle, the funds rate approached zero in late 2008, and has been there ever since. The unemployment rate, meanwhile, peaked at 10% in October 2009, and has fallen to 8.3% over the subsequent 18 months. If the unemployment rate were to continue falling at the same trajectory as it has been, history would suggest that the funds rate could start rising by the middle of 2013.

Exhibit 9: Interest Rates Poised to Rise?



SEI firmly believes that it is unlikely that the funds rate will be changed in 2012, even if economic growth and/or inflation surprises to the upside. However, the fixed-income market could become more volatile if investors think the Fed is falling behind the curve. We expect the pressure to tighten policy will become significant as the unemployment rate falls below 7%. This is just another reason to be cautious about Treasury bonds and other safe-haven assets.

The Greek Tragedy at Intermission

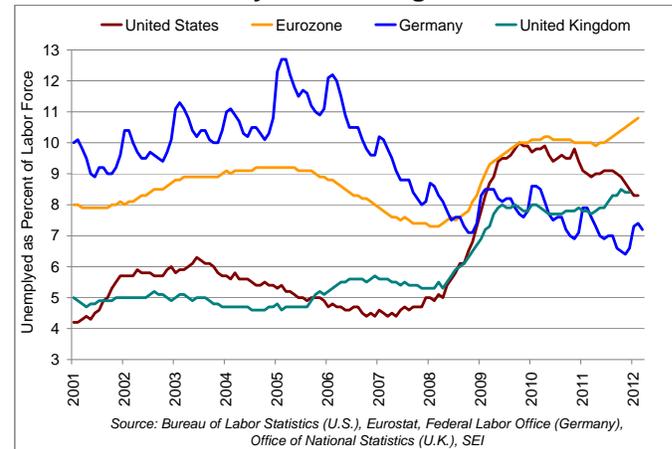
The good news has not been limited to America. The European debt crisis has been put on the back burner—at least temporarily. The European Central Bank's (ECB) two-stage, €1 trillion liquidity infusion into the banking system via its Long-Term Refinancing Operations (LTRO), the "voluntary" restructuring of Greece's debt held by private investors and the approval of more bailout money for that benighted country have eased the near-term crisis of confidence and the fear that the eurozone would fall apart.

SEI nevertheless remains skeptical that we have heard the last of bailouts or investor haircuts—and we are not alone. The current pricing of the restructured Greek debt implies that investors are betting on another crisis down the road. Last October, the International Monetary Fund (IMF) put together a "strictly confidential" white paper that was quickly leaked. It detailed the perilous state of the Greek economy, and highlighted the ongoing need for official debt support.

Although the IMF's baseline forecast calls for a Greek debt-to-gross domestic product (GDP) ratio of 120% by 2020,¹ the IMF acknowledges that the ratio could be considerably higher—above 150% in 2020—under more realistic assumptions of delayed economic growth, lower-than-forecast privatization proceeds and delayed access to market-based financing. However, even this forecast assumes a bottoming out of the Greek economy this year and a return to GDP growth in the 2% to 3% range by 2014. A continuation of the economic decline at the pace of recent years would lead to a debt-to-GDP ratio of more than 200% in the short run and only modest improvement by 2020 to a still-impossibly high 173%. While one should have a healthy disregard for any long-term forecast, it cannot be denied that Greece still has a tremendous challenge ahead of itself.

The richer European countries also need to be prepared to support the other debtors on the periphery. Portugal may need a second bailout next year, and Ireland has entered discussions with the European Union for a restructuring of its banking-sector debt. Although the mood has lightened somewhat in the aftermath of the Greek debt swap, we remain concerned that the eurozone will face a prolonged stretch of recession and/or subpar growth. GDP growth has been sagging in recent quarters for most countries in Europe, while the periphery debtors have sunk more deeply into recession. Even the Netherlands, one of the healthier “core” countries on the Continent, has dipped into negative GDP territory. Meanwhile, Germany seems to be going the other way economically, enjoying a sharp decline in its unemployment rate (see Exhibit 10) since 2005 and a rise in home prices. This good fortune may only serve to stiffen the German resolve to resist any attempts to soften the austerity measures being imposed upon other countries.

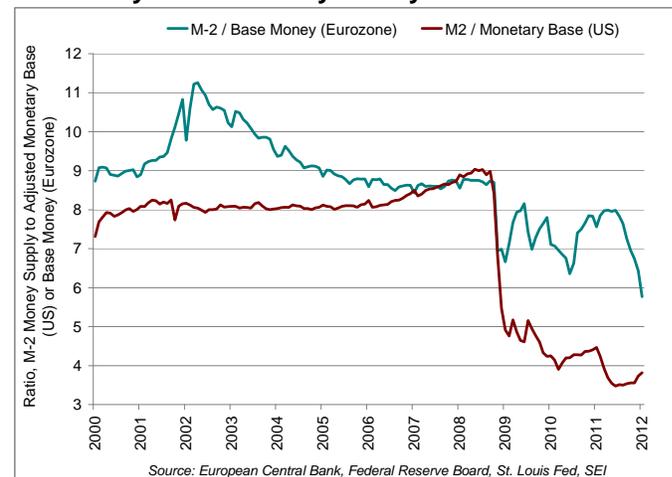
Exhibit 10: Germany Gets Stronger



Although the ECB's liquidity infusion was a very important and much-needed policy step, we do not think it will jump-start the European economy. The experience of the U.S. (or Japan and the U.K., for that matter) is instructive in this regard. Despite zero interest rates and two rounds of quantitative easing, it has taken three years for the U.S. expansion to gain traction. The Fed's efforts were certainly useful in helping the banks recapitalize and liquefy their balance sheets, but it did not lead to a sharp turnaround in credit creation.

Exhibit 11 shows the money multiplier (the money supply divided by the monetary base) for the U.S. and the eurozone. The U.S. multiplier has fallen steeply since 2008. The Fed created a huge amount of reserves, but the money supply stayed weak because banks chose to bolster their capital positions rather than create loans. Only in the past year has the U.S. money supply begun to grow at a solid pace and in sustained fashion.

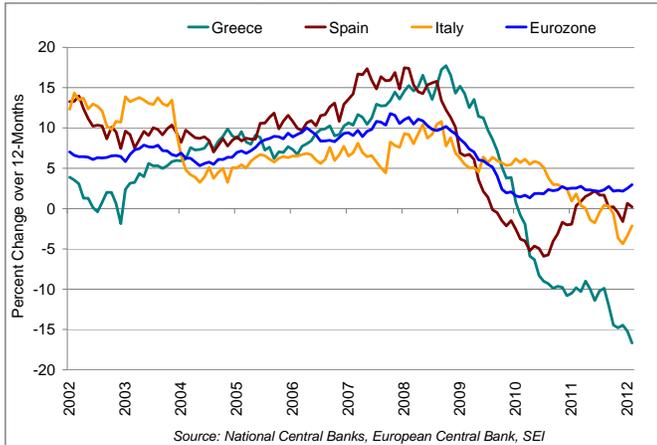
Exhibit 11: Easy-Money Policy Doesn't Always Lead to Easy Money



¹ Most economists believe that a 120% debt-to-GDP ration is still too high. It is, however, politically correct; the Italian debt burden is currently at this level. A 90% ratio is commonly cited as a maximum level that can be sustained, and a ratio below 60% would be ideal.

It would not be surprising if the ECB's massive provision of reserves to the banking system leads to a similar outcome, with money supply and credit creation showing little response as the banks use those reserves to build up their capital cushions. Notably, Exhibit 12 highlights how the money supply continues to contract in several countries, particularly Greece.

Exhibit 12: No Money to Spend



It is not surprising that equity markets have responded well to the latest developments in Europe. Although stocks in the United Kingdom have underperformed, markets on the Continent enjoyed a nice run that matched the year-to-date performance in U.S. equities in U.S.-dollar terms. This performance reflects the liquidity impact of the ECB's activities and sheer investor relief that an agreement with Greece was reached before the March 20 debt payment that could have precipitated a disorderly default.

We cannot help but wonder about the sustainability of this up-move. Additional bailouts are highly likely, and each negotiation will likely be drawn-out and uncertain affairs, corrosive to investor confidence. Political developments—highlighted by the elections in Greece and France within the next few weeks—could be a negative catalyst, with the more important electoral battle in the latter country.

President Nicolas Sarkozy is locked in a close race with the Socialist candidate François Hollande. It is a battle that seems designed to unnerve investors. The president is pandering to the far right, railing against immigration and threatening to withdraw France from the Schengen accord that allows for the free movement of goods and people across the borders of the eurozone.

Meanwhile, Hollande promises to soak the rich with a 75% top marginal tax rate on incomes above €1 million (resulting in an effective marginal tax rate of 90%). In addition, the Socialist candidate has promised to roll back the retirement age to 60 from 62 for those who have been in the labor force for 41½ years—one of the key reforms achieved by the Sarkozy administration.

The rhetoric and promises coming from the candidates beg the question “Are the voters of the second-most-important country in the eurozone prepared to engage in any significant attempt to roll back the welfare state?” Demographic trends in France and other European countries clearly suggest that the promises made to retirees and workers in protected industries—the social contract—have become too expensive to keep. Reforms need to be made. We see that the periphery debtors have no choice—they are making the tough choices with a gun (metaphorically speaking) to their heads. Richer countries such as France are more reluctant to change their ways.

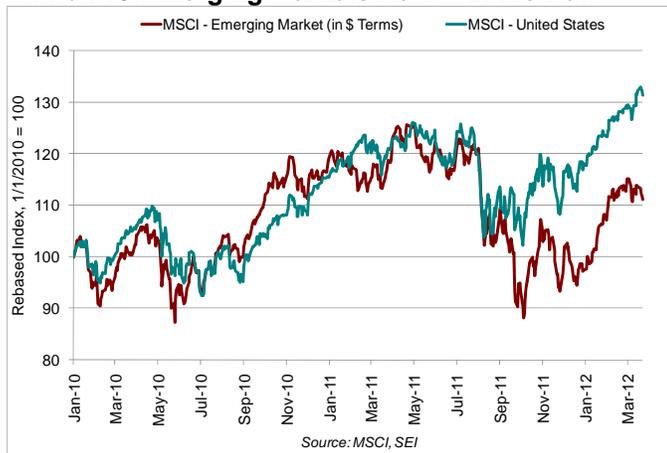
We are working with the following facts: (1) the government sector in France is considerably larger than in the U.S. (accounting for 56% of GDP versus 36%); (2) the French population is growing older faster; and (3) it does not enjoy what former French Finance Minister Valéry Giscard d'Estaing once referred to as the “exorbitant privilege” of having the world's reserve currency (or even the ability to print its own money). Consequently we would argue that France is moving toward a periphery-like reckoning. When the last Socialist president of France, François Mitterrand, entered office 30 years ago, he tried to impose policies near and dear to the political left. The financial markets rebelled. The French stock market plunged 33% within a month after the election and bond yields soared 250 basis points within five months. President Mitterrand was forced to retreat and pursue a more conservative path.

In our opinion, the need to make far-reaching reforms in the social contract in France and other advanced countries facing a surge in retirees has never been more urgent. Political developments in France—and investor reaction to those developments—should be closely watched as a leading indicator of what may occur elsewhere over the next few years.

Emerging Markets Join in the Fun

As might be expected in a strong global bull-market environment, emerging-market equities have participated in the advance, although the outperformance versus large-cap U.S. stocks has been relatively modest both year to date and since the October bottom. On a year-over-year basis, the underperformance of the MSCI Emerging Markets Index remains substantial versus the U.S. in dollar terms (as shown in Exhibit 13).

Exhibit 13: Emerging Markets Run with the Bull



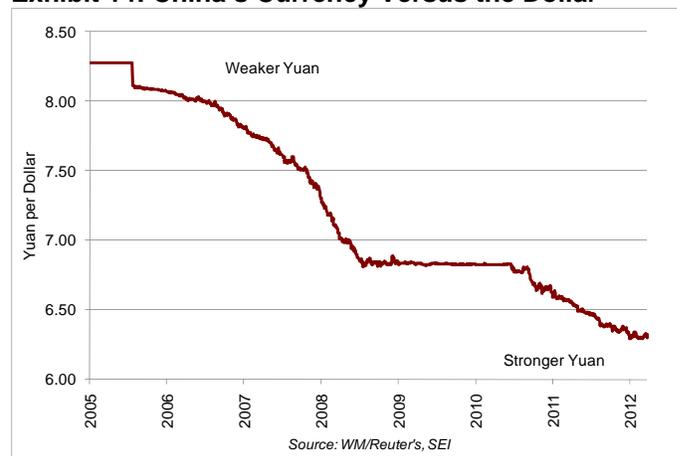
Mixed trends in growth and political uncertainties continue to keep us neutral toward the asset class. On the positive side, inflation has eased in the majority of emerging countries in response to lower food prices. However, this respite may be coming to an end. Grain prices have been perking up since December, led by a jump of more than 20% in soybean prices. Energy prices, of course, also have rebounded. The push toward lower interest rates and easier monetary policies may be nearing an end. Policy rates in Brazil, for example, have fallen sharply since the middle of 2011, as the Banco Central do Brasil leans against the slowing trend in the economy. Managing that economy has become trickier—consumer spending and credit growth have been quite strong even as industrial production dips into negative territory on a year-over-year basis.

The Bank of India, meanwhile, recently eased its policy rate by 75 basis points. As elsewhere in the emerging world, inflation has slowed sharply: The rate of increase in the CPI fell to 5.3% in January, compared against a year-over-year gain approaching 10% late last year. The real (inflation-adjusted) interest rate has been rising. Bond yields also remain uncomfortably high, owing to the government's poor financial management. A sharp deterioration in India's trade deficit had caused a great deal of currency volatility. The rupee fell 20% in the fourth quarter, followed by a small bounce last quarter.

China also continues to garner attention. The government lowered its annual GDP growth expectation last month to 7.5%. Since the published GDP numbers usually exceed projections, we are still comfortable assuming an 8% annual gain. No hard landing is expected. However, the past quarter has highlighted two interesting events—one political, one economic.

The purging of Bo Xilai, the party secretary of Chongqing province and a presumed candidate for the nine-person Standing Committee that rules China, hints at the political infighting at the highest levels of decision-making within the country. Bo had been a rather colorful character in China—the color red, to be precise. He was a populist who seemed to be encouraging a return to Maoist thought (although he was quite modern in other ways, including an ability to speak colloquial English). The second interesting event was the announcement by Chinese Premier Wen Jiabao that the yuan was close to its fair value against the dollar, following a 30% appreciation against the U.S. dollar since 2005. While this may just be rhetoric for domestic consumption, we also note that the yuan has held mostly steady against the dollar since last August. Exhibit 14 showcases the decline.

Exhibit 14: China's Currency Versus the Dollar



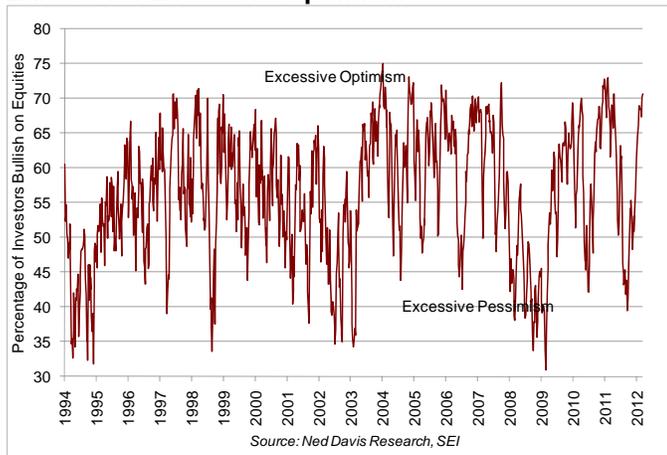
This could become a flashpoint with the U.S. in 2013, especially if Mitt Romney becomes president. The candidate has been quite vocal, criticizing China as a currency manipulator and unfair trading partner. Following a sharp rally in January and February, the MSCI China index has given up substantial ground. Relative to the S&P 500, Chinese equities are back where they were near the start of the year.

Sell in May and Go Away?

The exceedingly strong advance in equities and the general “risk-on” behavior of investors since last October naturally causes one to question the sustainability of the move. On the positive side of the ledger, the bull market started at a time when investor pessimism was at an extreme. Stocks in the U.S. were mispriced relative to the improving fundamentals. Even in Europe, fears over a pending currency or banking disaster were overblown; it was clear that the ECB and the politicians would at least try to kick the can down the road rather than allow a Lehman-like implosion.

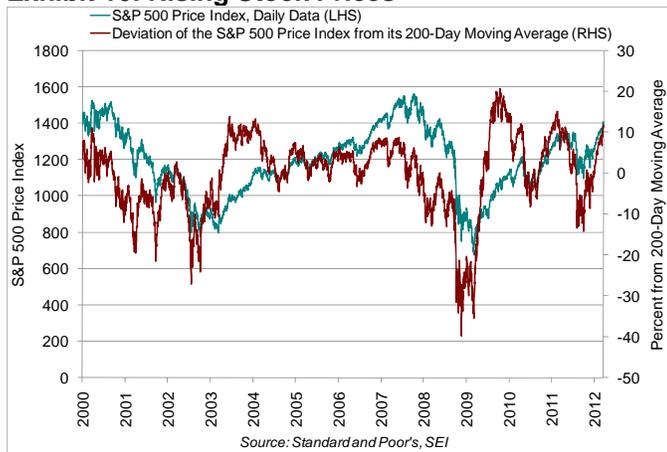
It can be fairly argued, however, that the risk-on trade is in need of a rest. A 30% rise from the October lows in U.S. equities may have been justified, but it has resulted in excessive near-term optimism. For example, the Crowd Sentiment poll tracked by Ned Davis Research has reached a very high level of optimism similar to that recorded during the first half of 2011, as demonstrated in Exhibit 15. Excessive bullishness on the part of investors does not mean that stock prices will suffer a big reversal in the near term, but it does suggest that the improvement in the economic outlook is mostly reflected in stock prices.

Exhibit 15: Excessive Optimism



In similar fashion, the rally in the S&P 500 price index has left that widely watched metric about 11% above its 200-day moving average, as seen in Exhibit 16. Again, this does not suggest that stock prices are dangerously high and that a bear market beckons. It simply suggests that equities are extended and are in need of a pullback or consolidation. A 5% to 10% reversal in the months ahead would not be the end of the world, however. These pullbacks should be viewed as dip-buying opportunities.

Exhibit 16: Rising Stock Prices



To conclude, our key tactical views remain unchanged:

1. We are neutral on stocks versus bonds, removing our tactical (short-term) overweight to equities across our portfolios and moving back to our strategic (long-term) positions. Although we believe equities are likely to experience a period of pullback and consolidation in the months ahead, we do not expect a severe reversal like the one seen last year. SEI believes that the U.S. expansion is finally on firmer ground. Although earnings growth will continue to ease as margins decline from the abnormally high levels achieved in recent years, the improvement in the financial position of households and the recovery in employment should give investors confidence that the economic expansion will be sustained.
2. We favor an overweight to U.S. versus international equities. The U.S. certainly looks like the best house in a bad neighborhood. Although Europe has made some progress in dealing with its periphery debt crisis, it will continue to face periods of stress. GDP growth in the strongest countries is likely to trail the U.S., while the problem debtors continue to face austerity-induced economic decline. European exporters may benefit if the euro declines as we expect. But investors are more likely to go where the growth is—according to the latest survey of economists conducted by Consensus Economics, the U.S. is forecast to have the best GDP growth among the 13 largest advanced economies in 2012 and the second-highest growth rate in 2013. Emerging markets will likely continue to grow at a faster clip than the U.S. but, as we pointed out above, China, India and Brazil all have issues that lessen their near-term attractiveness.
3. We favor an overweight to high-yield fixed income versus investment-grade fixed income. The emphasis on high-yield debt has paid off this year. The option-adjusted spread of high-yield debt over Treasuries has contracted by 130 basis points in the year to date; at about 600 basis points, the spread is still relatively attractive. The absolute yield, on the other hand, is nearing previous lows. The financial health of high-yield debt issuers suggests that this asset class should continue to outperform Treasuries and investment-grade bonds. But the potential for further declines in absolute yields is not as strong as it was three or six months ago. We still emphasize this asset class relative to core fixed-income, but we would reduce the overweight.

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