Economic Outlook

First Quarter 2013

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Investors Keep Calm and Carry On

- Although Europe is a mess, the U.S. markets keep growing.
- Can the growth continue?
- While past performance is no guarantee of future results, there are some signs that the answer is “yes.”

At times, it feels as if there’s a war out there. Investors have been subjected to a bombardment of bad news over the past few months. In the U.S., the fiscal cliff of economically damaging tax increases was averted at the last minute. Payroll taxes, however, went up for everyone, while marginal tax rates were increased on the most affluent. Next came the spending sequester and the (over-hyped) threat of long lines at airports, the degradation of the country’s defense capability, and interruption of economic and social support for the nation’s neediest. Although the initial impact has barely registered on the public’s consciousness, there are fears that chaos has been merely delayed. Meanwhile, the quarter ended as it began—with another deadline. This one was far less dramatic, as Congress and the Administration dispensed with last-minute brinksmanship and approved a continuing resolution that will fund the government through the end of the fiscal year.

The fun and games in Washington are more than matched by the root-canal economics in Europe. Fiscal austerity continues to take a huge toll throughout the region, driving the eurozone’s unemployment rate to nearly 12%—four percentage points higher than the prevailing jobless rate in the United States. Industrial production has been in a steady decline, even in the stronger, better-run economies. The only answer the elites can find to correct the situation? More austerity! Take the U.K. as an example. British Prime Minister David Cameron, invoking the image of the Iron Lady (former Prime Minister Margaret Thatcher), insists there is no alternative to the austerity that has been in place for the past four years. This stubborn persistence, however, did not prevent a downgrading of the country’s sovereign debt rating in February.

Meanwhile, the politics in Europe are even more trying than the economics. The Rajoy government in Spain is engulfed in scandal, the Italians have opted for political stalemate, and the European parliament has voted to sock it to bankers and fund managers with severe restrictions on compensation. A financial transaction tax looms on the horizon. As the quarter drew to a close, the “troika”—the European Union, the International Monetary Fund and the European Central Bank—has forced the Cypriot government to agree to a tax levy on uninsured bank deposits that will likely wreak havoc on the country’s economy and financial system. A new round of financial contagion and instability within the periphery could result.

One might think that this steady stream of bad news would leave investors paralyzed with shell-shock. On the contrary, markets have shown amazing resilience. The MSCI World index is up nearly 10% on a year-to-date, total-return basis. The U.S. and U.K. are up 10% in local-currency terms, while Japan has led the pack with a 20% return. Although the eurozone has lagged, climbing about 5% in local-currency terms, that performance seems surprisingly robust in the context of the region’s poor economic performance and the latest turn for the worse in the peripheral debt-crisis saga.

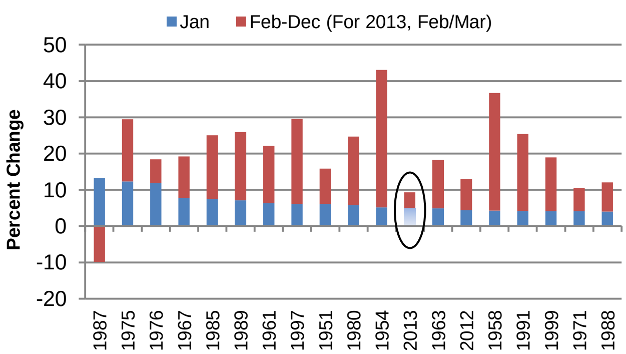
In another sign of investors’ revived risk-on behavior, the performance of the fixed-income markets during the quarter was tepid. (Although bond prices ended the period on a strong note, as investors hedged against a Cyprus-inspired decline.) The Barclays Global Aggregate Bond Total Return Index, for example, eased about 2.3% during the quarter, and the Barclays Emerging Market (USD) Total Return Index fell 1.4%. However, the Barclays High Yield Corporate Bond Index returned 2.8%, reflecting the equity-like character of that particular fixed-income asset class.

A Fast Start Often Means a Good Year

Surprising strength in equities during the first quarter followed equally surprising strength in last year’s final quarter and 2012 as a whole. Equity markets, both developed and emerging, are closing in on or are above their 2007-2008 highs. Can this momentum hold?

History suggests it can. In the U.S., the S&P 500 (S&P) gained 5% in price-only[1] terms during January. This is the best performance to start off a year since 1997. More often than not, a strong January has been followed by better-than-average equity performance through the rest of the year, a relationship known as the 'January Barometer.' Going back to 1950, when the stock market has posted a positive January performance, the S&P 500 price index has registered an additional 11.86% over the rest of the year. When January has been weak, the February-through-December result has been virtually flat (-0.04%).

Exhibit 1: The January Barometer



Sources: Ned Davis Research, Standard & Poor's, SEI
Years when January return exceeded 4%; data since 1950

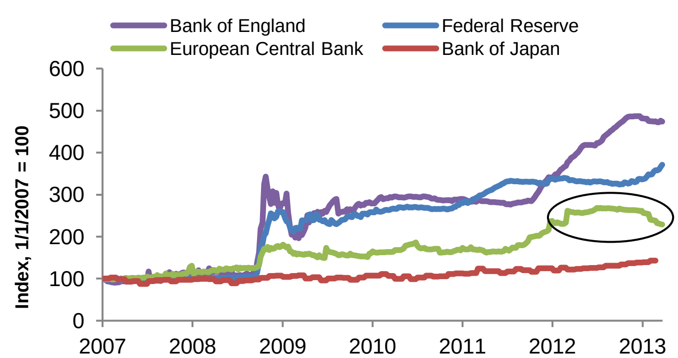
This past January's performance ranks as the twelfth strongest of the last 63 years. In Exhibit 1, we look at all the years when the stock market has risen more than 4% in the month of January. The typical performance over the rest of the February-December period has been excellent—an average gain of 15%. Note that there is only one year in this sample when prices fell in the February-through-December period. That was in 1987, when the S&P sustained a one-day collapse of 20% on October 19. But keep in mind that stock prices climbed an additional 23% from the end of January to the peak of the market on August 25. That works out to a 39% year-to-date gain when one includes the record January increase of 13.2% that started off the year.

During February and March of this year, the S&P rose an additional 4.3%. The year-to-date gain is still middling by the historical standard of the January Barometer. That said, we've found it hard to chase the market. Last year, U.S. equities also got off to a fast start, rising 4.3% in January. We didn't get a significant correction until the April-to-June period. Maybe we're facing a similar situation, where investors feel compelled to jump on the bandwagon now, ignoring the bad news that's still lurking out there.

We recognize that the January Barometer and other technical indicators based on historical price patterns are slim reeds upon which to base a forecast of future prices. Economic fundamentals and valuations must come into play too. At this point, the most powerful fundamental force pushing risk assets to new levels is the activity of global central banks. With the recent noteworthy exception of the European Central Bank (ECB), monetary policy appears lined up on one side of the policy spectrum—to provide as much liquidity as possible to keep interest rates at exceptionally low levels.

We highlighted Exhibit 2 in our last quarterly Economic Outlook, but it's worth showing again. The chart tracks the changes in the balance sheets of the U.S. Federal Reserve (Fed), the Bank of England (BOE), the ECB and the Bank of Japan (BOJ). The downturn in the ECB's balance sheet sticks out like a sore thumb. While ECB President Mario Draghi announced last July that he would do "whatever it takes" to save the euro and the eurozone, his actions in recent months show a more hard-nosed approach. Not only has he resisted the temptation to cut the ECB's policy lending rate, but he has also allowed the central bank's balance sheet to turn sharply to the downside since December. This decline in the ECB's assets is the result of banks paying back loans originally given to them under the Long-Term Refinancing Operation program. While Mr. Draghi downplays the economic impact of this balance-sheet contraction, we can't imagine Ben Bernanke allowing such a tightening, passive or not, to happen under similar circumstances in the U.S. Indeed, quantitative easing in the U.S. remains in full swing. Since the start of the year, the Fed's assets have grown over 10%, while the ECB's assets have fallen more than 12%.

Exhibit 2: Battle of the Monetary Bulge



Sources: Bank of England, Bank of Japan, European Central Bank, Federal Reserve, SEI

The BOE has also experienced a contraction in its balance sheet. It's been milder than the one sustained by the ECB, however, and it follows an extraordinary expansion last year. We would speculate that the BOE's balance sheet will begin to expand again in the months ahead. Incoming BOE Governor Mark Carney has

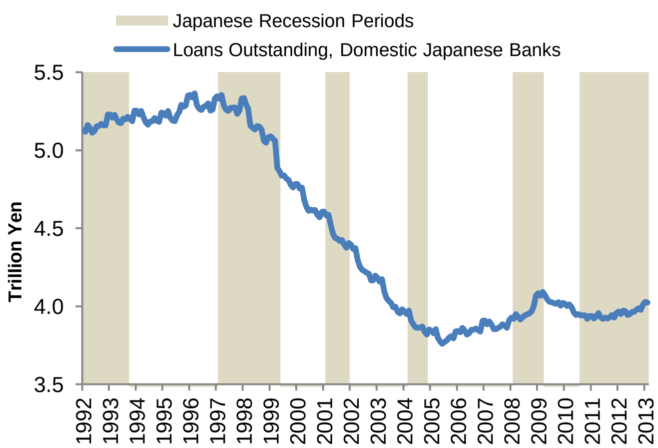
[1] The S&P 500, generally quoted, is a price-return index that does not account for dividends; it only captures the changes in the prices of the index components.

signaled his intention to "think out of the box" when it comes to implementing monetary policy. This view is in keeping with that of David Cameron and his Chancellor of the Exchequer, George Osborne, that monetary policy needs to do the "heavy lifting." Unfortunately, fiscal policy in the U.K. promises nothing but Churchill-like "blood, toil, tears and sweat."

In Japan, the selection of Haruhiko Kuroda as BOJ Governor ensures that the central bank will pursue a more aggressive monetary policy, as desired by newly elected Prime Minister Shinzo Abe. Note that Japan has been the least aggressive central bank in terms of expanding its balance sheet in response to the 2008 financial crisis. We fully expect Japan to make up for lost time, which should keep the yen under downward pressure on a trade-weighted basis for the foreseeable future.

At this point, the Japanese economy is still quite recessionary. But we view both the yen's weakness and the stock market's remarkable strength as leading indicators of better times ahead. In addition, we are encouraged by the increase in loans outstanding seen in Exhibit 3.

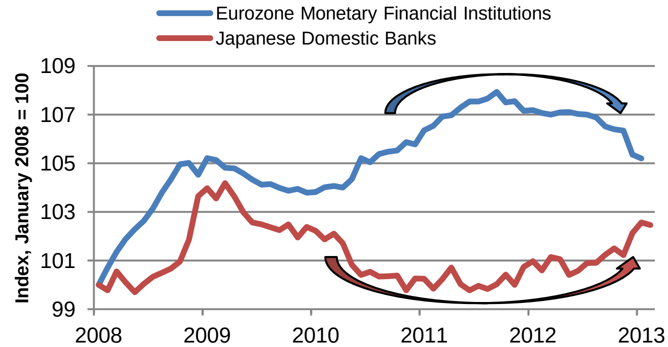
Exhibit 3: Loans Rise in the East



Sources: BOJ, Federal Reserve Bank of St. Louis, OECD, SEI

The recovery shown in Exhibit 3 predates the Abe regime but has accelerated since his return to office in November. This is very different from what's happening in Europe, where loans to households and non-financial businesses have been contracting for almost 18 months, as shown in Exhibit 4.

Exhibit 4: Japan Advances While Europe Retreats



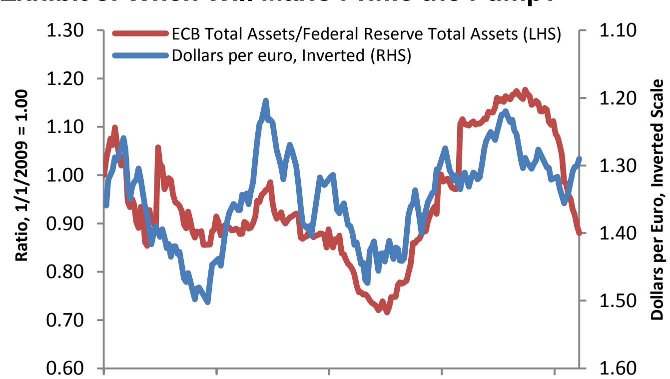
Sources: BOJ, ECB, SEI
Loans Outstanding to households and non-financial businesses

Will the ECB Fire the Next Shot?

Following its mystifying (at least, to us) rise to 1.37 versus the dollar two months ago, the euro has fallen back to the 1.28 mark. (One euro now buys \$1.28 instead of \$1.37.) We viewed the euro's previous strength as the result of the resetting of speculative positions following a series of good-news events that began with the Greek debt restructuring last spring. Mario Draghi's "whatever it takes" vow in July 2012, signs of fiscal progress within the periphery, and the technical monetary policy tightening caused by the pay-down of Long Term Refinancing Operation loans, are probable causes behind the move up in the currency to levels we judged to be counter-productive to the eurozone's recovery and repair.

Exhibit 5 shows the close correlation that has existed between the euro/dollar relationship and the relative expansion of the Fed's and ECB's balance sheets in recent years. Obviously, there has been an important divergence in this correlation over the past two months; although the Fed's assets have expanded at a time when the ECB's balance sheet has contracted, the euro has weakened considerably against the greenback.

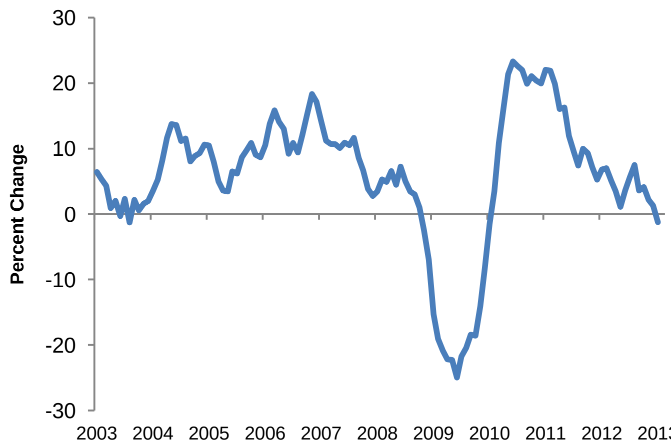
Exhibit 5: When Will Mario Prime the Pump?



Source: ECB, Fed, SEI

The political and economic setbacks of the past two months in the eurozone help to explain the euro's more recent weakness. We believe there is a pressing need for additional euro decline—and not just for the sake of the beleaguered periphery countries or an increasingly uncompetitive France. Even Germany is facing intensifying competitive pressures. Exhibit 6 specifically highlights Germany's sagging export performance. Following a strong recovery from 2009 through mid-2011, German exports have plateaued and fallen below year-ago readings. The country's manufacturing orders from other euro-area members have been in sharp decline since mid-2011, the result of the region's recession. Orders from outside the euro area have held up until now, but could come under pressure as a result of the Japanese yen's sharp depreciation against the euro.

Exhibit 6: German Exports go in the Wrong Direction



Sources: Deutsche Bundesbank, SEI
Three-month moving average of year-over-year percent change

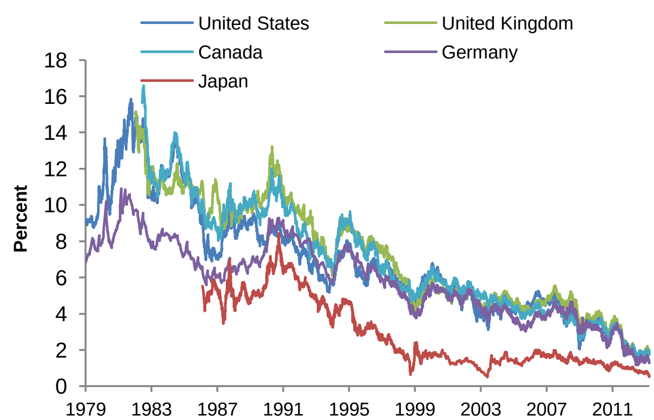
This deterioration in export performance could soften Germany's opposition to a cut in the ECB's policy rate or the roll-out of a more forceful quantitative easing strategy. German federal elections, moreover, will be held in September of this year. No politician ever wants to go into an election with a sagging economy. Angela Merkel is undoubtedly the most popular and powerful politician in the country, but we suspect that even she will be reluctant to press the austerity theme too hard in the months immediately ahead. That said, foisting additional austerity on other countries—Cyprus is the latest example—continues to resonate well with the average German voter, which complicates any path toward a durable resolution of the periphery debt crisis.

The upending of the Cypriot banking system over the past few weeks is a clear sign that the debt crisis in Europe is far from resolved. Although we may not see Spain and Italy back in the cross-hairs, the smaller countries with deeply rooted debt woes—Slovenia, Greece and Portugal—remain vulnerable to another bout of investor flight. Once capital controls are removed, we are likely to see heavy outflows from Cypriot banks that could devastate the local economy. But it might also knock investor and consumer confidence in other peripheral countries that continue to struggle with oversized banking sectors and economically stifling debt burdens.

Bond Yields: D-Day Delayed

The angst over Cyprus has buoyed the bond markets of safe-haven countries, pushing yields on 10-year bonds below current and expected inflation. German and Japanese 10-year benchmark yields, for example, have declined to 1.26% and 0.52%, respectively, and are nearing previous all-time lows. The global secular bull market in bonds may be nearing an end, but it evidently still has some life left in it. Exhibit 7 shows that the bond-yield decline across several countries has literally lasted for a generation—a 30-year trend. Although deflationary Japan has been the outlier, with its benchmark bond yield falling faster and to lower levels compared to other major countries, the trends have been similar across countries over time.

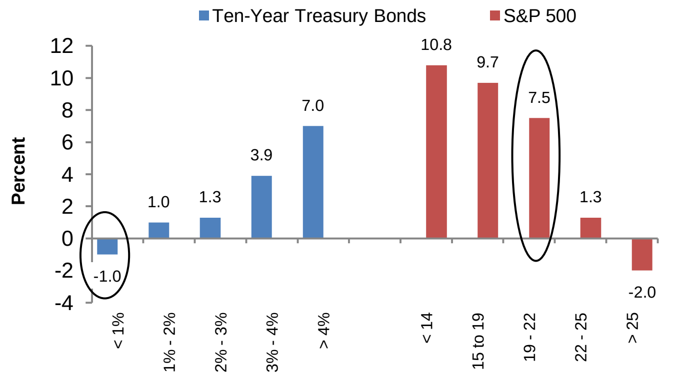
Exhibit 7: Rates Slide and Slide and Slide



Sources: Tullett Prebon Information, SEI
Annualized yield on 10-year government debt

We firmly believe, however, that safe-haven bonds will turn out to be poor investments over the next five-to-10 years relative to equities. According to the Bank Credit Analyst (and as shown in Exhibit 8 on the following page), when inflation-adjusted yields on U.S. Treasury bonds are below 1%, as they certainly appear to be today, the annualized real return over the following five years has averaged negative 0.1% per year. By comparison, the S&P 500 has provided an average inflation-adjusted total return of 7.5% per year at today's normalized price-to-earnings ratio of 22 times.

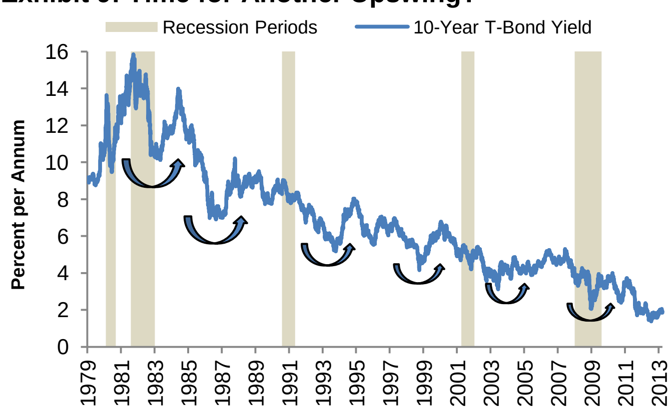
Exhibit 8: Stocks Lose Battles, Win the War



Sources: Bank Credit Analyst, SEI
Annualized total return over the five years following purchase
Left side of horizontal axis shows inflation-adjusted Treasury yield at time of purchase; right side shows normalized S&P 500 price-to-earnings ratio at time of purchase.

Exhibit 9 shows that, even in the context of this historic secular bull market in bonds, there have been six periods over the past 30 years when Treasury yields have increased two percentage points or more. The last cyclical bear occurred in 2008-09. How close are we to the next one? Unfortunately, that is still a hard question to answer. Under normal circumstances, we would argue that in a world of 2% inflation, a nominal 10-year yield of 3.5% to 4% would be appropriate.

Exhibit 9: Time for Another Upswing?

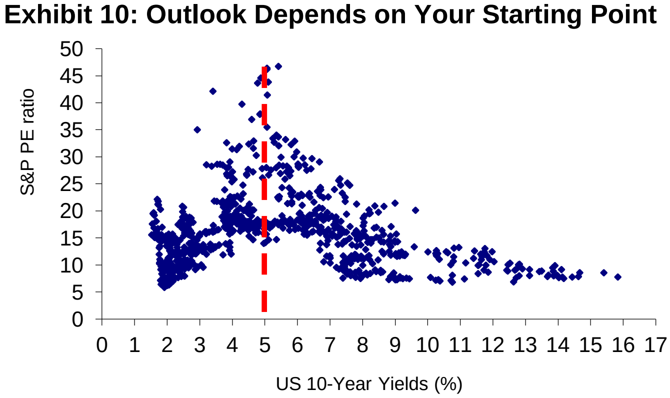


Source: Fed, National Bureau of Economic Research, SEI

But circumstances are hardly normal today. There are a few reasons why we think that bond yields will continue to trade well below levels we consider to be fair value. First and foremost, the quantitative easing activities of central banks are soaking up the vast supply of bonds that deficit-ridden countries are spewing out. This layer of demand will not disappear anytime soon. Prolonged zero-interest-rate policies also serve to lower the term structure of yields. Additionally, the lingering effects of the financial crisis and the ongoing efforts of households, financial institutions and governments to reduce the debt on their balance sheets have constrained global economic growth and have short-circuited the inflationary potential of aggressively expansionary central-bank policies. While we expect market pressures to build, we think yields will rise only grudgingly over time as central banks lean hard against this rising trend. We believe economic growth and inflation would need to surprise dramatically on the upside for bond yields to begin a meaningful climb.

For the sake of argument though, let's assume that the bull market in bonds suddenly ends and yields rise sooner than expected. We disagree with the view that a bear market in bonds would drag equities down too. On the contrary, if fixed-income markets fall because economic growth is picking up, we would look upon that as a positive for both stocks and investor expectations. Exhibit 10 compares the correlation between bond yields and the price-to-earnings ratio of the S&P 500. This chart, based on work done by Myles Zyblock, strategist at RBC Capital Markets, clearly shows that the *level* of interest rates—not just their direction—is a key determinant of how equities respond to interest-rate changes. When bond yields are below 5%, the correlation between interest rates and stock multiples is a positive one—as bond yields increase, so do price-to-earnings ratios. In contrast, when bond yields are above 5%, the correlation between rates and the price-to-earnings ratio tends to be negative—the higher bond yields go, the lower stock multiples are likely to be.

Exhibit 10: Outlook Depends on Your Starting Point



Sources: RBC Capital Markets, Robert Shiller, SEI
Data covers 1936 to 2013.

Keeping an Eye on Politics

A popular military slang word during World War II that remains with us today is SNAFU, an acronym for "Situation Normal, All Fouled Up." We can't think of a more apt description for the current political milieu. In a slowly growing or outright recessionary world, the impact of politics and the influence of politicians increase dramatically. After all, politics is all about the distribution of a society's resources through non-economic means. Unfortunately, history shows that politicians rarely get it right. The more intrusive the state becomes in the functioning of the economy, the greater are the chances that wealth will be misallocated. A company in the private sector that fails to provide the right service or product will lose money and eventually go bankrupt and disappear, thereby freeing resources up for a more efficient producer or builder of a better mousetrap. A government can continue to misspend indefinitely (until creditors pull the plug, that is), providing a good or service that may not even be wanted.

The financial crisis of 2008 demanded extraordinary monetary and fiscal actions by governments to prevent a wholesale collapse of the global financial system. But the fallout from the crisis and the consequences of decisions made then continue to reverberate today. A more direct and activist government role in industrial policy (including finance, industry, healthcare and energy), increased social safety nets, and higher taxation on wealth and income are by-products of the crisis. They may or may not serve a good purpose, but they will surely impede the recovery in private sector economic activity.

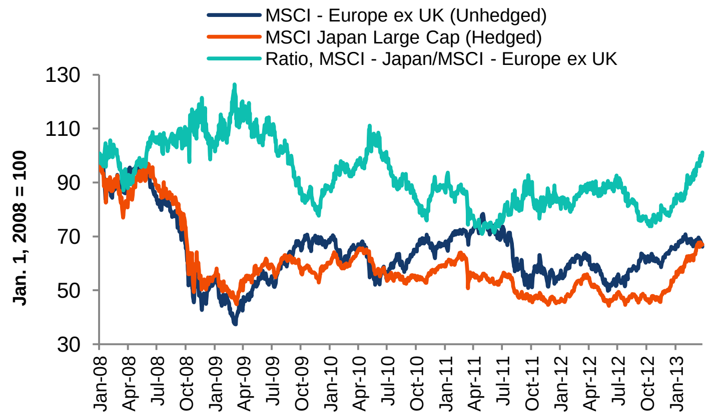
While governments in most countries are held in low esteem by the electorate nowadays, the outcome of the recent Italian election speaks volumes. The results not only show that the country's electorate is suffering from a bad case of austerity fatigue, but that it may also be ready for a radical change in leadership. Italians were willing to vote not only for the devil they know (Silvio Berlusconi) but also a devil they don't (Beppe Grillio). We hold little hope an effective government can be formed. Indeed, Democratic party leader Pier Luigi Bersani recently said, "Only an insane person would have an itch to govern Italy right now." At the very least, Italy's restructuring efforts may be delayed by the political gridlock.

As the recession drags on, we look for more leadership changes in Europe. This may be a good thing, if more growth-oriented policies are put in place. But the uncertainty that arises as the establishment parties are replaced by something else could unnerve investors in the interim. In our opinion, politics is another reason to underweight Europe in investor portfolios.

Portfolio Positioning

At this stage of the cycle, we expect stock markets to rally on good economic news, even if bond prices react negatively. Of course, there's enough political and economic uncertainty in the world that it is difficult to make sweeping generalizations even within asset classes. We currently have an overweight position in favor of Japanese equities in our active asset allocation strategies, but remain cautious on European equities and the euro. This position has been a good one for our mandates. Since we established the position at the end of January, the Japanese equity market has outperformed European equities by roughly 13 percentage points. Exhibit 11 tracks the performance of the Japanese and European equity markets.

Exhibit 11: Tokyo Rose



Sources: MSCI, SEI

We are looking to add to our U.S. equity exposure versus bonds on a market pull-back, but it has been a somewhat frustrating wait. As the best house in a bad neighborhood, the U.S. stock market has ground higher amid signs that economic growth is on relatively firm footing. While we believe emerging market equities are attractive in the long term, opportunities for excess return in the near term appear easier to achieve from the bottom up than the top down.

In fixed income, we favor shorter-than-benchmark duration. We also favor credit over government debt in some of our active-asset mandates. We have been neutral on the bond/stock call in the short term, but expect equities to be the better-performing asset over the next five to 10 years.

Index Definitions

The **Barclays Emerging Market Bond Index** is an unmanaged index that tracks total return for external-currency-denominated debt instruments of the emerging markets. The Index reflects reinvestment of all distributions and changes in market prices.

The **Barclays Capital 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 **Barclays Capital U.S Corporate High-Yield Bond Index** is composed of fixed-rate, publicly issued, non-investment grade debt. The Index reflects reinvestment of all distributions and changes in market prices.

The **MSCI Europe Ex-UK Index** is a free float-adjusted market-capitalization-weighted index designed to measure the equity-market performance of the developed markets in Europe, excluding the United Kingdom.

The **MSCI Japan Index** is an equity index of securities with a large market capitalization generally incorporated in Japan and available to investors worldwide. Securities listed on the Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ or the Nagoya Stock Exchange are eligible for inclusion.

The **MSCI World Index** is a market capitalization weighted index composed of companies representative of the market structure of Developed Market countries in North America, Europe and the Asia/Pacific Region. The index includes reinvestment of dividends, net of foreign withholding taxes.

The **S&P 500 Index** is an unmanaged, market-weighted index that consists of the 500 largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market.