# Economic Outlook

First Quarter 2014

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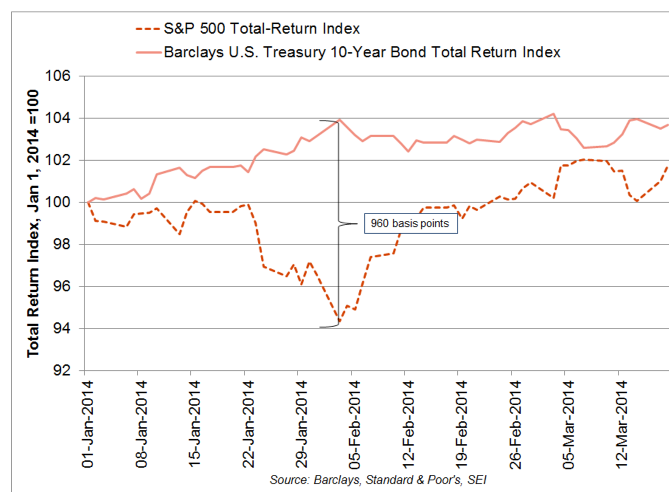
## An Economic Thaw, but a New Cold War

It's hard to keep a good bull down, but every once in a while it needs to catch its breath. Equities have turned a bit more volatile this year—and for good reason. Disruptive cold and snowy weather during the first quarter has made recent economic data coming out of the U.S. statistics mills about as reliable as those that are made in China. The invasion of the Crimean peninsula by Russian troops has raised the specter of a renewed cold war. Throw in the longer run worries surrounding the political, economic and financial health of several emerging countries, and one might expect investors to go into permanent hibernation.

On the contrary, following a brief dip in the latter part of January, global stock markets bounced higher, with the U.S. leading the way. Year to date, the MSCI U.S. Index is up 1.8% in total-return terms. While this probably doesn't sound like much after its 32% surge in 2013, the ability of equities to quickly overcome periodic stumbles (in the U.S. and other developed markets, at least) underscores investors' willingness to assume risk even when economic and geopolitical uncertainties are on the rise.

Comparing the performance of equities to bonds drives home the point. From the start of the year through February 3, the Barclays U.S. Treasury 10-Year Index outperformed the S&P 500 Index by 9.6 percentage points in total-return terms. From that high-water mark through the end of the quarter, bonds have traded in a narrow range; but the S&P 500 Index has almost completely closed the performance gap, as seen in Exhibit 1. In 2013, the outperformance of the S&P 500 Index amounted to a stunning 40 percentage points. Since the start of the bull market in stocks five years ago, equities have outperformed the bellwether 10-year bond by almost 190 percentage points—stocks have more than doubled in total-return terms, while bonds have appreciated by 18%.

**Exhibit 1: Stocks stumbled out of the gate, then hit their stride**




In our previous quarterly Economic Outlook ("Partying Like It's…2013?"), we suggested that the outperformance of equities versus fixed income could continue as mutual fund investors finally shift back into stocks after a long multi-year absence. The fact that equity pullbacks remain brief and shallow suggests that this rotation out of cash and fixed-income assets and into stocks is still very much in play. Since the yields on Treasury and investment-grade corporate bonds remain low relative to their own history and to inflation, we continue to expect more volatile assets (equities, high-yield debt and emerging-market debt) to outperform less volatile ones.

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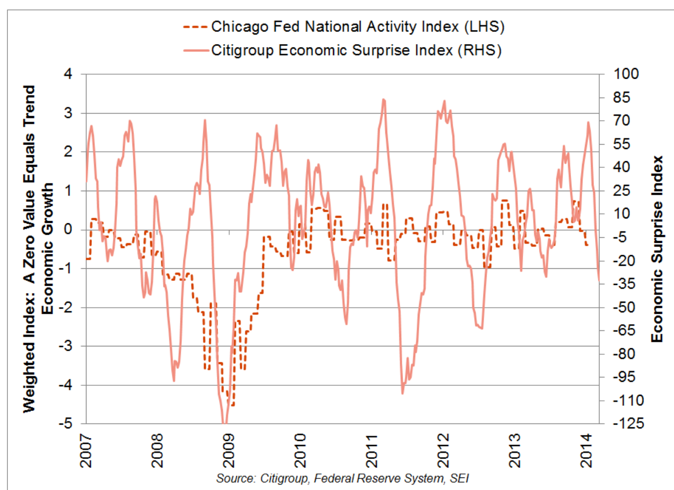
## Waiting for the U.S. economy to spring back

There is no disputing that weather has depressed economic activity in recent months. Citigroup's Economic Surprise Index turned sharply lower beginning in January, hitting its lowest point in almost 20 months, as seen in Exhibit 2. The persistent trend in this measure coincides with a string of poor economic outcomes. Employment; home sales and construction; industrial production; new orders for durable goods; the Purchasing Managers' report on manufacturing and retail sales have all undershot expectations at least once in the past quarter. The Chicago Federal Reserve (Fed) National Economic Activity Index, a composite of 85 monthly indicators highlighted in Exhibit 2, suggests that the U.S. economy was tracking below trend during the first quarter.

**Exhibit 2: Surprise, surprise: economy turns cold**



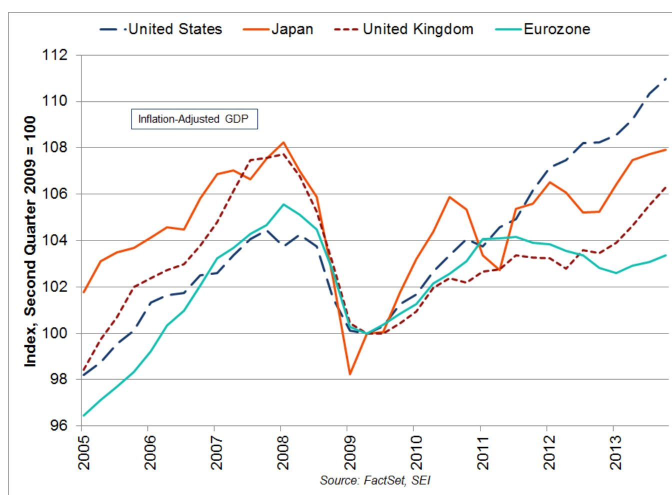

Some economists worry that there's more underlying weakness than can be explained by weather alone. Although that's a minority view, we share in the frustration that the recovery from one of the deepest recessions since the Great Depression remains one of the weakest. Since the recession's bottom in second-quarter 2009, inflation-adjusted gross domestic product (GDP) has advanced at a meager 2.4% annual rate. By comparison, the economic expansions that followed the recessions of 1973 to 1975 and 1981 to 1982 were more than twice as strong as the current one this far into the upturn. The saddest fact is that this lackluster performance looks downright stellar compared against those of the other major developed economies. Exhibit 3 provides a comparison.

So what accounts for the resiliency of the U.S. and other developed stock markets in the face of the disappointing news flow? Four factors stand out in our opinion:

1. *Earnings have been solid in the U.S. and Japan, and are expected to gain traction elsewhere this year.*

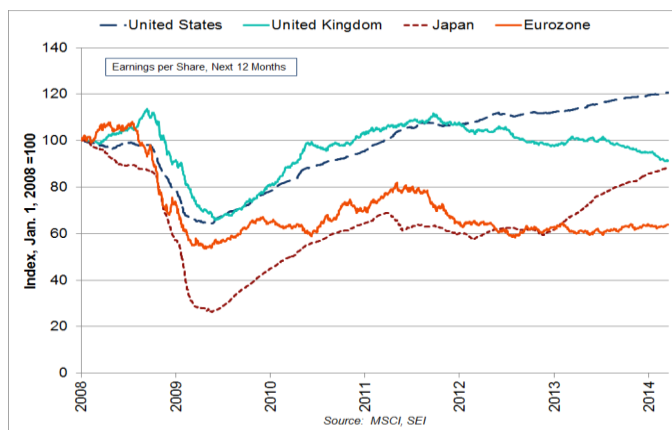
The final quarter of 2013 was an upbeat one for corporate earnings, with S&P 500 companies posting a 9% year-over-year gain on a per-share operating basis. Although revenues continue to expand at a snail's pace, profit margins remain at historically high levels. Granted, security analysts are downgrading their first-quarter expectations in light of the economy's weather-induced weakness. But these revisions do not show any real concern that the sluggishness will extend beyond the winter months.

**Exhibit 3: Real GDP: better, not great**




Using MSCI data, one can see in Exhibit 4 that forward-looking estimates of earnings per share (EPS) continue to move into new-high territory, with the latest EPS forecasts more than 20% above the 2008 peak.

**Exhibit 4: Bottom lines go in different directions**

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Companies in the U.K., by contrast, have not benefited very much from the rather vibrant economic recovery that country is enjoying—underscoring the effect global economic conditions have on U.K. companies' bottom lines. Analysts' earnings forecasts are still in retreat, with EPS reaching their lowest level since 2010. It's not surprising that the U.K. stock market has been one of the weaker performers among developed stock markets.

The profits picture is quite mixed elsewhere, as shown in the same chart. Within the eurozone, analysts' forecasts of EPS have been bobbing along in a narrow range since mid-2012; although one can argue that this in itself is an improvement versus the declines sustained in 2008 and 2011. This earnings trend seems consistent with the improved, albeit still-mixed, economic data that eurozone countries are releasing. Forward profit margins in the eurozone have also been expanding strongly in recent months, although this has served mostly to offset a continuing plunge in top-line revenues.

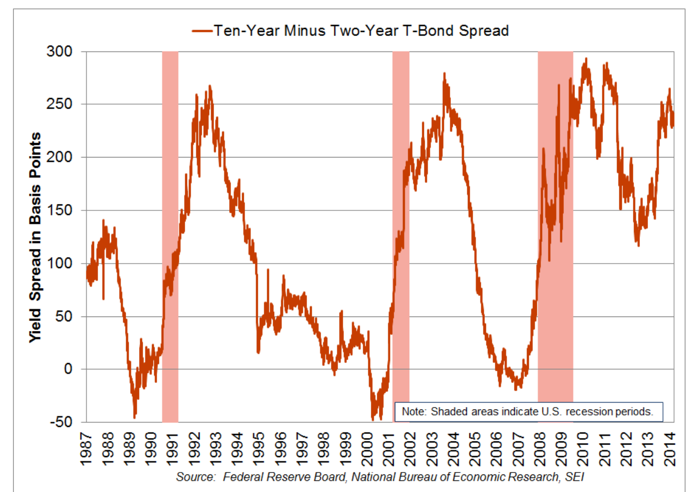
In contrast, Japan's expected earnings trend has been enjoying a sharp rebound since 2012, benefiting from the yen's decline, quantitative easing (QE) and fiscal stimulus measures of Prime Minster Abe. Unlike the Japanese stock market itself, which has slumped 7.4% year-to-date, Japanese security analysts have yet to be spooked by concerns that the package of economic, monetary and societal reforms (otherwise known as Abenomics) might be losing its punch.

2. *Fed policy under new Chair Janet Yellen is expected to remain investor friendly.*

In her initial appearances in front of Congress, Ms. Yellen took pains to emphasize the steady-as-she-goes character of monetary policy. Serving as Vice Chair of the Board of Governors since October 2010, it should not be a surprise that she agrees with the policy choices of the Bernanke years. It is also clear that investors have made peace with the idea of steadily tapering QE, with bond purchases declining by an additional $10 billion following each Fed meeting. At this pace, the taper will conclude before the end of the year; although the central bank will continue to reinvest cash flows to maintain the size of its portfolio.

Ms. Yellen surprised markets at her first post-Federal Open-Market-Committee-meeting press conference when she defined a "considerable period"—the time between ending QE tapering and the first possible Fed funds rate increase–as six months long. This immediately brought into question how long the Fed funds rate will remain near zero. It has been the consensus view that the Fed would keep short-term rates anchored near zero well into 2015; now an increase as early as April of next year is being priced in.
The yield curve (highlighted in Exhibit 5 as the spread between 2-year and 10-year Treasurys) is likely to flatten over time as the Fed shifts away from its ultra-loose policy position. However, given the extreme starting point, with 2-year notes some 230 basis points below 10-year bonds, the curve will likely remain steep through 2015. Recessions usually begin a year or two after the yield curve flattens and inverts (for example, short-term rates move above those further out on the curve), since an inverted curve is symptomatic of tight liquidity and corporate financial stress. Thus, it's way too early for markets to discount a cyclical downturn.

**Exhibit 5: Not much dread in the yield curve spread**



Source: Federal Reserve Board, National Bureau of Economic Research, SEI

Unfortunately, investors will now face a higher degree of uncertainty regarding the Fed's intentions. Gone are the clear quantitative thresholds that focused on the unemployment rate and expected inflation. In their place is an undefined basket of labor, financial and inflation indicators that the Fed governors will take into account. Nor is the Fed the only central bank to make a transition to a broader, more discretionary and more nuanced reaction function. The Bank of England (BOE) is facing the same problem as the Fed; the U.K. unemployment rate is falling rapidly to its threshold level, but the central bank has little desire to start tightening in response. BOE Governor Mark Carney is depending instead on a mosaic of statistics to determine how close the economy is operating to full capacity, a process that is much more complex than relying on a particular level of unemployment and expected inflation. The European Central Bank (ECB) is exploring the same issue along the lines of the BOE.

An increase in policy flexibility, no matter how pragmatic, boosts the noise-to-information ratio for investors. If market participants cannot be sure that policy rates will stay near zero until certain objective economic measures are met, then there will be a tendency to act first and ask questions later, as we saw during Ms. Yellen's press conference. Market rates can be expected to fluctuate more sharply on signs of recovery as investors anticipate

an earlier move away from the current near-zero interest-rate regime.

*3. U.S. fiscal policy has disappeared into the background.*

House Majority Leader John Boehner's successful push to pass a "clean" debt ceiling bill with substantial Democratic support helps take that issue off the table for the next year. Even problems surrounding the Affordable Care Act are becoming less of an issue as the president makes unilateral decisions to delay important elements of the mandate at least through the 2014 mid-term elections, if not past the 2016 presidential cycle. Of course, delay does not cure the uncertainty that employers and individuals face. We still see regulatory uncertainty as a major headwind impeding economic growth. On the downside, not much legislatively will be done between now and the mid-term elections in November. Immigration reform and the Trade Promotion Authority (aka fast-track) are among the casualties.

The political calendar is busy elsewhere in the world too, with presidential and legislative elections being held in some 40 countries this year (not including the sham election in North Korea or the illegal one in Crimea last month). In the emerging world, voters in India, Brazil, South Africa and Indonesia are going to the polls. Turkey recently had its election with the incumbent party winning despite charges of corruption lodged against the prime minister. These elections merely add to the uncertainty bothering investors, even though political change may eventually lead to better economic outcomes and less corruption. Developments in the Ukraine and Crimea have taken the spotlight in recent months. But riots and political instability in Turkey, Egypt and Thailand as well as outright war and terrorism in Syria and Iraq continue unabated.

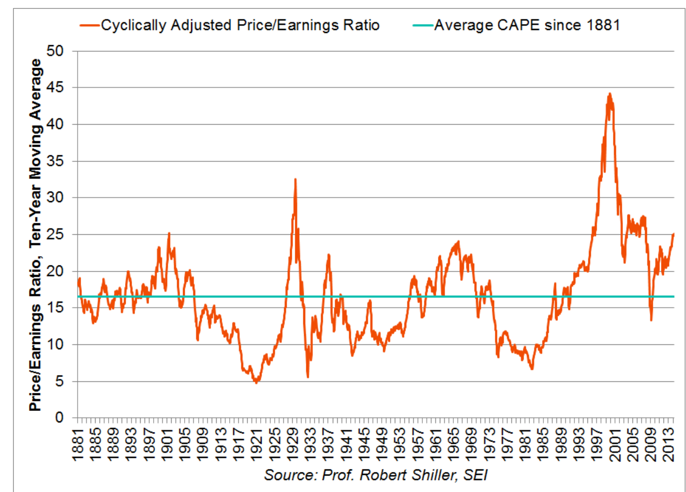
In the developed world, the run up to the European Union elections in May could have a market impact if anti-establishment politicians make unexpectedly large gains. In this regard, Marine Le Pen's National Front party did well in France's municipal elections. President Hollande was forced to sack his prime minister following the Socialist Party's dismal showing.

*4. Valuations are elevated but not yet at nosebleed levels.*

The U.S. stock market is among the more expensive markets in the world today. Yet its price/earnings ratio and other metrics of value appear well within the historical norm—especially against the fundamental backdrop of very low interest rates, a still-expansionary monetary policy and further improvement in economic growth and corporate profitability. Although significant market corrections have historically taken place at lower valuations than exist today, one needs to keep in mind the factors that made the stock market vulnerable at those times. In the 1970s, for example, interest rates and inflation were extremely high, pushing multiples down to low levels.

Exhibit 6 highlights the cyclically adjusted price/earnings ratio (known as the CAPE), which Professor Robert Shiller of Yale University made famous in his book *Irrational Exuberance*. The CAPE measures the current level of the S&P 500 Price Index against the average of reported earnings over the previous 10 years. Market observers with a bearish bent tend to favor this measure, arguing that stock prices have reached unsustainably high levels versus the long-run trend of corporate profitability. At a value of 25 times, the CAPE does indeed look extended versus most time periods, except for the crazy valuations achieved during the "this-time-is-different" bull markets of the late-1920s and late-1990s.

**Exhibit 6: CAPE in hand**




The CAPE crusaders, though, have been wrongly warning about an overvalued stock market for most of this bull market expansion. The CAPE is only a reliable valuation tool in the long term. Although there is a strong inverse correlation between the level of the CAPE and future stock market performance (the higher the cyclically adjusted price/earnings ratio, the poorer the future performance of the stock market), the consistency of those outcomes are much higher when the time horizon is expanded to five and ten years. It's a mistake to forecast equity performance over a one- or two-year time frame using this statistic.

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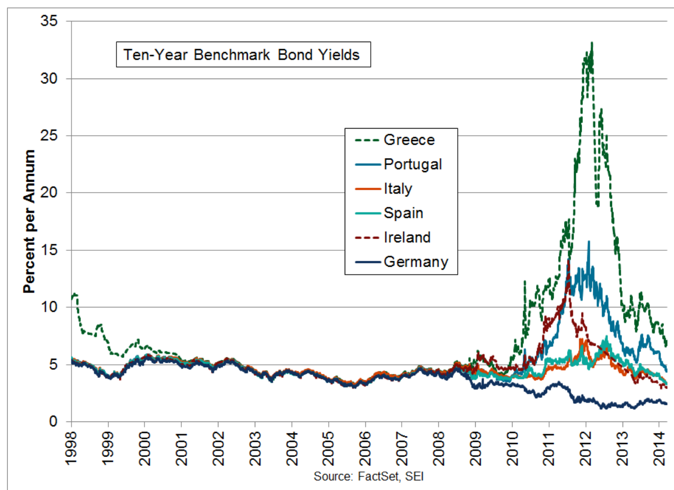
**Green shoots in need of fertilizer**

The eurozone is enjoying its best economic performance since 2010—but the recovery still looks fragile to us. Real GDP in the region advanced 0.3% in the fourth quarter versus the third quarter (translating into an annualized gain of 1.1%) and 0.5% over the past four quarters. There has been some pickup in private household consumption and an even bigger expansion in government-related consumption through the third quarter as austerity pressures have faded. Despite this, we still believe that the eurozone is a fair distance away from the sort of sustained expansion currently playing out in the U.S., the U.K. and, more haltingly, Japan.

The health of the banking system is still in question. Lending to businesses and households continues to be quite weak, although lending standards have eased somewhat in recent quarters. Unlike the U.S., where households have managed to reduce their debt as a percentage of income, debt burdens remain near their peak levels in Europe; this is especially true in the periphery, where recession and price deflation have increased the real burden of the debt.

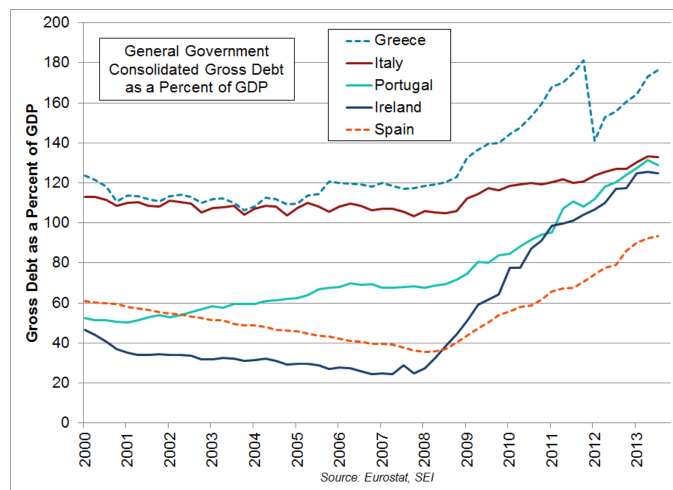
Despite the continuing struggles of the periphery debtors, investor sentiment has improved in stunning fashion. Bond yields have fallen sharply, both in absolute terms and relative to German bunds (Exhibit 7).

**Exhibit 7: Periphery yields plunge…**




There is a strong appetite for Portuguese, Spanish, Irish and Italian paper. This has allowed the periphery to tap the bond markets and slow the painful debt deleveraging process. There has been no downturn in the ratio of sovereign debt to GDP, as highlighted in Exhibit 8. This is also the case in the private sector.

**Exhibit 8: …But periphery debt doesn't**




The huge declines in periphery yields reflect:

1. An improvement in fiscal positions, with some countries now running primary fiscal surpluses (before interest payments on the debt). Debt is still high relative to GDP, but Italy, Ireland and Portugal are no longer significantly adding to their debt burdens.
2. The elimination of the risk of a currency break-up.
3. Some cross-over demand as investors move away from emerging markets.
4. Falling inflation through the eurozone, with the periphery countries either near a zero price change over the past year or experiencing outright deflation.

We are most concerned about the last point, and are keeping a close eye on eurozone inflation rates. The steady decline in non-periphery core-country consumer price indexes to a pace well below the ECB 2% target is worrisome**.** Meanwhile deflation in the periphery only serves to impede the recovery.

Growth in the region will almost certainly continue to be subpar. The economic improvement in the eurozone maintains a two-steps-forward-one-step-back quality. Industrial output is improving noticeably in Germany, but appears to be flat lining elsewhere. Recovery in the labor markets is virtually nonexistent (Exhibit 9). At 11.9%, the overall eurozone unemployment rate remains stuck near its cyclical high. The unemployment rate in the eurozone compares poorly against the 7.2% rate for the U.K. (down from a high of 8.4% in November 2011) and the current 6.7% in the U.S. (the peak of 10% was reached in October 2009).

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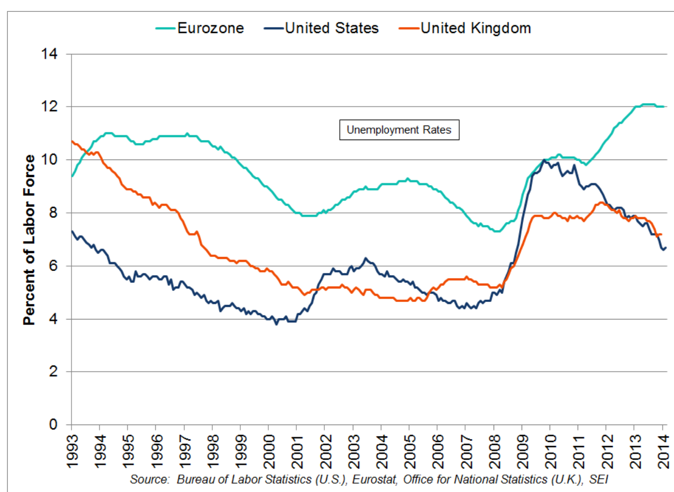
**Exhibit 9: Labor's love is lost**




The fading of the debt crisis and the easing of fiscal austerity have undoubtedly improved the prospects for future growth in the eurozone. Capital has flowed into eurozone bonds and equities since Mario Draghi's famous pledge to do whatever it takes to defend the euro; but we also continue to believe that the ECB's reluctance to counteract the decline in its balance sheet threatens to worsen the disinflationary impact of the rising euro.

We are looking for a role reversal in the conduct of monetary policy. The Fed is expected to become incrementally tighter (or, more accurately, less expansive) as QE is tapered between now and year end; the odds of an increase in U.S. policy rates will lengthen as we progress through 2015. Meanwhile, we anticipate the ECB will become incrementally more expansive in order to provide relief to the banking system and stanch the downward pressure on inflation.

## When putsch comes to shove

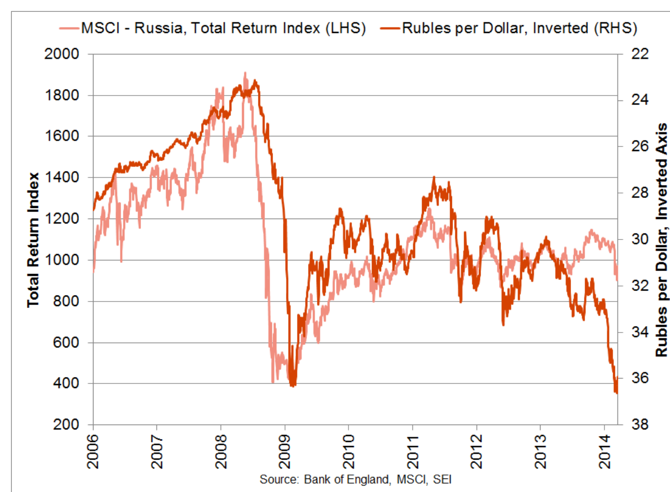
Emerging-market equity rebounded toward the end of the quarter, but our near-term optimism has ebbed. Although the valuation argument is intact, with relative multiples versus the U.S. market near decade-long lows, both political and economic factors have reduced our conviction that the value in emerging-market equity will be realized quickly.

The obvious political factor is Russia's invasion of Crimea. Political tensions are likely to remain high for an indefinite period, as the U.S. and its allies seek to punish Russia for its aggression. Economic sanctions are the only step western nations are willing to take—there will be no reenactments of Tennyson's Charge of the Light Brigade into the Valley of Death. Even then, there are questions about how painful and effective those sanctions will be, given Europe's dependence on Russian gas supplies.

As Exhibit 10 shows, however, foreign investors have been quicker and more aggressive in delivering punishment. Both the Russian stock market and currency have fallen sharply, although the plunge in the ruble started well before the invasion of Crimea. In any event, the ruble's value is now lower than it was during the 2008 financial crisis (a time when oil prices also plunged, to a low of $35/barrel from a high of $140/barrel in just six months).

Over the last three years, Brent crude has traded mostly between $100 and $120, with the price currently around the middle of that range. We're waiting to see if the U.S. government will decide to release crude from its Strategic Petroleum Reserve and allow its export. Enlisting the services of Saudi Arabia, which has the capacity to substantially increase oil production relatively quickly, would provide an even greater counterpunch to Russian aggression. These actions could exert severe downward pressure on international oil prices over time, hurting the Russian economy and leading to a much weaker equity market than we have seen thus far in the crisis. In the longer run, accelerating the approval process of liquefied natural gas export facilities and reducing Europe's vulnerability to energy blackmail must be the priority. Since the Russian stock market accounts for 6% of the MSCI Emerging Market Index, prolonged weakness in Russian equities and the ruble would act as an important headwind impeding overall emerging-market equity performance.

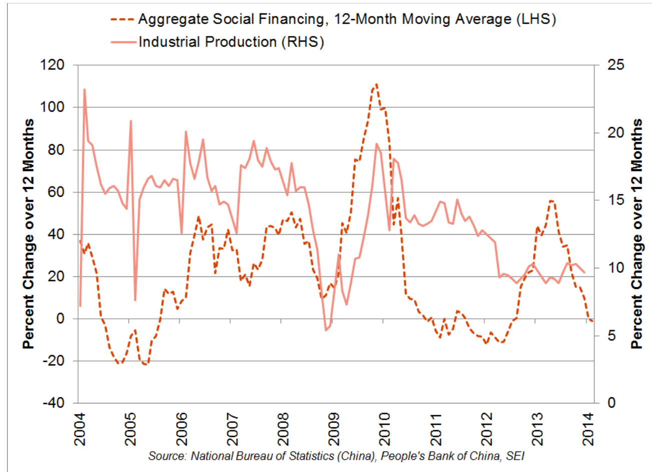
**Exhibit 10: Crimea and punishment**




Beyond the Crimean crisis, the nagging concern over China's growth prospects and corporate-debt burden is taking longer to dissolve than we hoped. Although a soft economic landing is still likely, it is turning out to be a harder soft landing. The deleveraging of the economy is a complicated undertaking that could result in more volatility in the months ahead. Aggregate fundraising by non-state entities, including individuals and non-financial corporations (referred to as Total Social Financing) went

from 120% of GDP in 2008 to 200% of GDP by the end of 2013. The rate of growth slowed dramatically in 2010 to 2011, but so did industrial output. See Exhibit 11.

**Exhibit 11: China begins delivering a deleveraging**



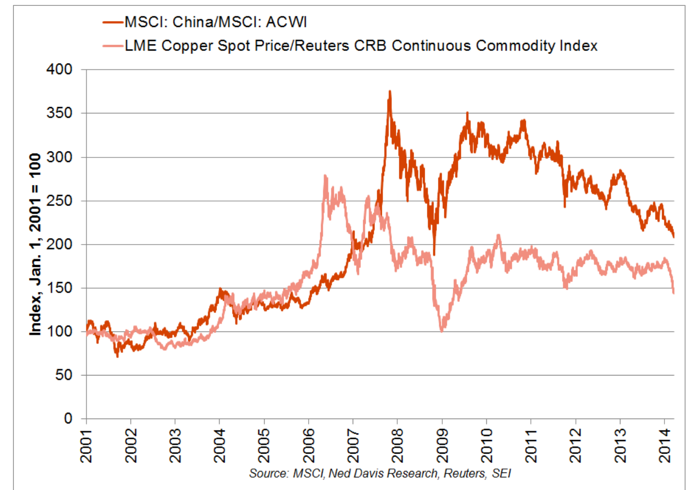

Following another jump in credit growth in 2012, the government is once again trying to engineer a second slowdown. Although industrial production growth has been maintained at a 10% rate for the past two years or so, the possibility of a further slowdown cannot be ruled out. We note that China's manufacturing Purchasing Managers Index fell to 48.1 in March, one of the lowest readings since the financial crisis in 2008.

Other developments in China that have reduced our conviction of a quick turnaround in the MSCI Emerging Market Index include the apparent decision of the government to push its currency lower against the dollar. The depreciation has been modest—only 2.9%—but currency traders took highly leveraged bets on the Chinese yuan on the assumption that an appreciation against the dollar was a one-way bet. It's hard to tell how important this shift in currency trends might turn out to be. Did the authorities simply want to bloody the noses of currency traders? Or was it just a seasonal quirk associated with the lunar New Year (Chinese exports, for example, were down a hard-to-believe 18% in February, measured on a month-to-month basis)? Or has the government allowed a more substantial and longer-lasting depreciation to boost export growth as it simultaneously tried to rein in real estate speculation and the shadow banking system? If it's the latter, dollar-based investors will not be able to count on a steadily rising Chinese currency as an additional source of return. China makes up 20% of the MSCI Emerging Market Index, so a sustained period of increased volatility in the yuan would be problematic.

There is one other concern about China. Although commodity prices have shown some resilience in the year to date, with the Commodities Research Bureau Index trading at its highest level since October 2012, copper has taken a nasty dip in the last few weeks.

Exhibit 12 shows how closely the Chinese stock market tracks the general direction of copper prices. This should be no surprise, since China represents some 40% of the world's consumption of the red metal.

**Exhibit 12: China is sick, according to Dr. Copper**




The sluggish pace of global economic growth and high inventories both inside and outside China suggests that demand for copper will remain tepid and prices will be weak. In addition, copper's price weakness stems from its use in China as collateral by companies and investors. The drop in the copper price is turning out be as much a financial barometer as an economic one. While Chinese stock prices relative to the All Country World Index recovered before the price of copper turned up relative to the CRB Commodities Index in 2008, we are concerned that will not be the case this time around.

The final disappointment with regard to emerging markets has been the inability of the U.S. Congress to advance the Trans-Pacific Partnership (TPP) trade agreement in a fast and efficient manner. We were hopeful that the Obama Administration would push strongly against Senate Majority Leader Harry Reid's opposition and seek a bipartisan vote on Trade Promotion Authority legislation. That was not meant to be. The president's approval ratings are stuck in the low 40s, making it necessary to placate his base of support in the run up to the mid-term elections in November. A fight over trade would have threatened to divide the party at a time when the Democrats have enough problems defending the Affordable Care Act and keeping their Senate majority.

Of course, U.S. politics isn't the only factor behind the delay in reaching an agreement. In Japan, entrenched interests are fighting back hard to maintain extremely

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high tariffs in place of rice, beef, poultry and other agricultural products considered “sacred.” While the TPP talks will continue, there will be no vote until Congress grants the president fast-track authority. Given political necessity, it is not likely to happen until 2015—if it happens at all. This delay in opening markets to additional trade reduces our growth expectations for the Pacific Rim region.

Although the lack of a trade agreement is not the end of the world in our view, it does take away one of the catalysts for growth that we were counting on in the near term. At this point, cheap valuations are not enough. Investors need some good news as an investment rationale, particularly at a time when there is a greater comfort level investing in developed stock markets. We want to emphasize, however, that we are not writing off the asset class. Emerging-market equity possesses diversifying characteristics that make it an attractive strategic holding.

## Portfolio Positioning

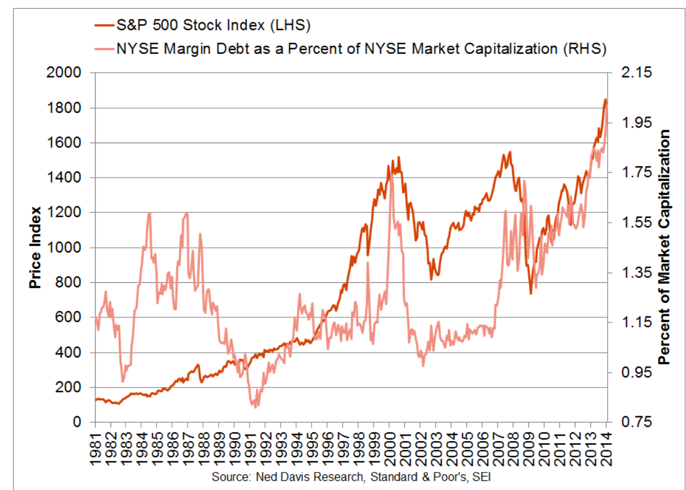
Geopolitical concerns and a further easing of inflation pressures around the globe sparked a stronger rally in sovereign debt than we expected at the start of the year. However, performance has been good in the fixed-income areas our managers have been emphasizing, especially high-yield and dollar-denominated emerging-market debt. A bias toward a flattening yield curve also has been helpful. Our fixed-income managers continue to like structured products, especially non-agency commercial and residential mortgage-backed securities. Nonetheless, there is a slow de-risking process underway in anticipation of higher yields in the months ahead. Although we think the Fed will pursue a dovish course, we continue to expect some firming of bond yields by the end of the year as rates attain a more normal relationship vis-à-vis expected inflation.

Relative to other fixed-income assets, high-yield securities still look modestly attractive. We expect improving economic fundamentals to keep default rates low. If Treasury yields drift higher, as we expect, high-yield spreads versus Treasurys are expected to compress further; however, if rates spike upward, like they did in May and June of last year, high-yield spreads would likely widen instead. Emerging-market debt, meanwhile, has enjoyed surprisingly strong inflows. More than $100 billion of hard-currency sovereign and corporate issuance has been absorbed, mostly by institutional investors. Deals continue to be oversubscribed by at least two or three times, underscoring the strong demand for the asset class.

In equities, the excessive investor enthusiasm in developed markets that prevailed at the start of the year has eased; the negative sentiment toward emerging-market equity, as we detailed in this report, has not abated for the most part. Most of the debate among our managers is whether we are still in the early stages of the bull market cycle or have transitioned to a mid-to-late cycle bull. If we are in a latter phase, the market will likely favor companies that can deliver earnings growth.

Momentum strategies were quite successful in January and February but hit a road block in March. We are mindful that momentum-focused markets can become dangerous as participants crowd the same trade and leverage up in an effort to improve returns. The surge in margin debt as a percentage of equity market capitalization (Exhibit 13) is an early warning that a stock market bubble could develop. The biggest risk we see is the momentum game becoming over-extended. Meltdowns are usually the result of melt-ups. At this point, though, a focus on quality-growth stocks appears appropriate.

**Exhibit 13: Margin is enlargin’**



Source: Ned Davis Research, Standard & Poor's, SEI

Globally, stocks in Europe are well bid despite the tepid growth we mentioned earlier. There has been a shift in relative performance, with more domestically oriented sectors outperforming those that are export dependent. The best-performing sector in Europe has been utilities. Our managers think this convergence play has more to go. With the exception of low-volatility strategies, our U.K. and European managers favor industrials, technology and consumer discretionary sectors and are underweight consumer staples. In the short term, our European managers are looking for pockets of opportunity. Valuations are not stretched, and there is conviction that global growth will accelerate.

In alternative strategies, managers are adding to their equity exposure as the environment improves for bottom-up stock picking. Short positions, however, are not hurting performance this year because the market is less directional. Investor reaction to earnings has also become more understandable, with good results

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rewarding company share prices and disappointments hurting company share prices.

Activist investing and mergers-and-acquisition strategies also are contributing to performance. Opportunities in the event-driven space are expanding and transactions are getting bigger. In fixed income, alternative strategies are more balanced, with yields and spreads not offering any big opportunities, in our managers' opinions. Most of the emphasis is on structured credit, such as commercial and residential mortgage-backed securities.

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