Commentary

October 2013

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The Debt Ceiling Redux: A Time for Calm, Responsible Money Management

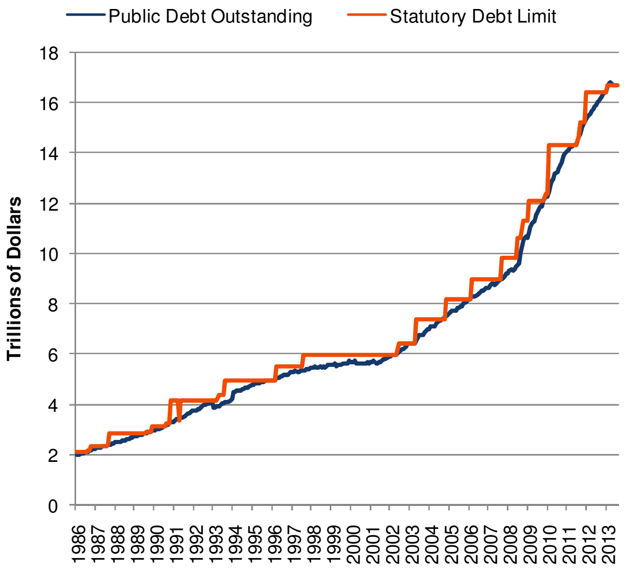
- While political shenanigans in Washington, D.C., are causing volatility, markets have performed well year to date.
- With the threat of a government default, stress tests conducted by SEI indicate our strategies should perform in line with the market.
- Despite concerns about default, we believe politicians will avoid the worst-case scenario.

Images of World War II veterans facing barriers on the National Mall marked the highpoint of Act I in Washington's latest political theatre. The closure of national parks and some government offices were visible manifestations of the partial government shutdown. Now the curtain has risen on Act II, with the looming threat of a government default.

The Concern

Unless Congress raises the debt ceiling, the U.S. Treasury's authority to borrow funds is expected to run out around the middle of October, as Exhibit 1 shows. Should legislators fail to authorize additional borrowing, the nation will be unable to pay its bills, including the interest due on government debt.

Exhibit 1: Mounting Debt



Source: U.S. Department of the Treasury, SEI

Under the most pessimistic scenario, default on the nation's debt obligations would push the country into recession. SEI does not expect a worst-case-scenario outcome.

The Reality

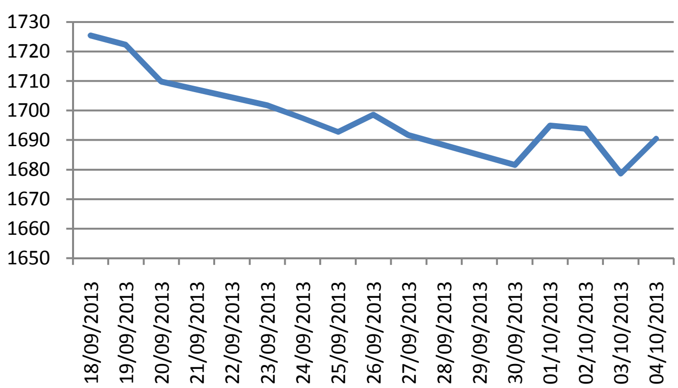
Despite dire predictions and calendar-date projections, the government has the ability to manipulate its payment schedule to avoid default at least for a period of time. Additionally, the intense partisanship between Democrats and Republicans, as well as between the House of Representatives and the Administration, only goes so far. At the end of the day, politicians of all stripes are first and foremost concerned about being reelected. While a two-day default or some other short period of time might be a possibility, the aftermath of a two-month default would be unthinkable for politicians seeking reelection. "We've managed to sink the country into recession and tank the global economy" isn't a campaign slogan anyone wants to run on.

The Markets

The imminent threat is a Treasury bond default, yet markets have responded to crisis with a flight to safety—investors are buying Treasurys. Bill Lawrence, Managing Director of SEI's Fixed Income team said, "The U.S. Treasury market is the largest, most liquid market in the world. If you have a trillion dollars to invest, like China does, there is simply no place else to put it. Even in the event of a technical default, the government will make interest payments in arrears. Looking past the headlines, the debt-ceiling crisis is good for the bond market. Outside of the October date range, investor interest is pushing up the price on Treasurys. A continuation of the shutdown will result in reduced gross domestic product growth, which is good news for bonds. It could also further delay the taper and hurt profits for stocks, which is therefore good news for bonds. Finally, the damage to the confidence resulting from a dysfunctional government is also bad for equities and good for fixed income."

On the equity side, the S&P 500 Index has posted stellar performance year to date, up approximately 20% through close of business October 4. This impressive run has pushed stock price multiples to elevated levels. One-year forward-price-to-earnings ratios currently exceed 14 in the U.S. and are above 12 for slower growing Europe. Valuations are not at unsustainably high levels; however, they are high enough to leave equities vulnerable to a price correction in the face of unexpectedly bad news. So far, in response to the current crisis, domestic equity markets have declined only marginally, giving back just 2%. While a price correction of more than 5% in the S&P 500 Index could occur as the budget drama unfolds, our strategy would be to buy on the decline.

**Exhibit 2: Markets Respond With a Yawn;
S&P Down 2%**



Source: FactSet

The Stakes

SEI's Risk Management ran a stress test to see what the "typical" client experience may be in a repeat of a 2011-style debt-ceiling impasse scenario. Looking only at the alpha (excess return) impact, our domestic equity portfolios could be expected to perform more or less in line with the broader equity market. An underweight to financials and overweight to technology should prove helpful, as well as short positions in selected currencies, including the euro and the yen. Our equity managers are still positioned for a muddle-through scenario—away from deep cyclical and defensive names, and focusing on less economically sensitive companies.

A flight-to-safety effect would likely prove more challenging for our fixed-income positioning (again, from an alpha-only perspective). The largest losses would be attributed to our exposure to leveraged loans, collateralized loan obligations and short-duration positioning. Overall, we would expect to perform no worse than the market in general based on our positioning.

Our View

Neither we nor any of our managers anticipate a long-term default. Things will work out in the end; but as the deadline approaches, increased volatility is expected. The specifics of what happens next are anyone's guess. It is likely that any agreement on the debt ceiling will be a temporary one. This would allow for additional negotiation and provide a path toward a grander compromise that includes funding of the budget, a debt-ceiling increase for the entire 2014 fiscal year and a modification of the sequester in exchange for entitlement reform. Alternatively, the debt ceiling could be raised without granting a continuing resolution to fund the government. This would avert disaster but maintain the status-quo level of governmental dysfunction. In any event, no responsible politician wants to throw the economy into disarray by allowing a technical default of the government. Memories of the debt-ceiling debacle of 2011 are still too fresh.

Our Strategies

In preparation for the coming weeks, our fixed-income strategies are taking reasonable precautions. We are not buying government paper that is set to make interest payments or mature between October 17 and October 31. While we are generally underweight Treasurys, and our core, long and global Funds have extended the duration of their holdings, they remain short against the benchmark; our positioning has more to do with valuation than with the debt ceiling. We continue to favor high-quality corporate bonds over government debt, and we also like agency mortgages. Bill Lawrence said, "We are value oriented. We like the valuations in these areas, so we are buying."

Greg McIntire, U.S. Large Cap Portfolio Manager at SEI said, "Our managers, as most, believe this will be resolved in a way that avoids default. These sorts of investment calls have a lot of risk and little information. Expect our managers to react to conditions rather than predict. If anything, I would expect buying at the margin on names that come under pressure in advance of a resolution. Calm, responsible money management is the right thing to do, and that is what we are doing."

Index Definitions

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

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