Commentary

Economic Outlook

Second Quarter 2012

SEI New ways. New answers.

Investors' Lament: "No Cure for the Summertime Blues"

By: James R. Solloway, CFA, Managing Director, Senior Portfolio Manager

- A deepening debt crisis in Europe. Signs of a pause in global economic growth. Gridlock in Washington.
- These same issues faced investors in the summer months of 2010 and 2011, causing a pullback in equity prices and a scramble to safe havens.
- In this environment, we expect markets to remain choppy and news-driven going into the November elections.

Global equities peaked in early April and fell sharply in May. The poor market action was not a complete surprise to us. In our last quarterly commentary, we noted that equity valuations had become mildly elevated following the six-month surge in prices from the lows of October. At the time, we speculated that the S&P 500 might sustain a 5% to 10% reversal. As it turns out, from the peak in early April, the S&P 500 price index fell almost exactly 10% by early June, before rebounding in recent weeks.

Three months ago, we thought such a decline would represent a good buying opportunity. That may still be the case, but economic and political uncertainties have intensified in the intervening months. Although our concerns have not risen to the point where we are compelled to reduce our equity exposure to an underweight position versus our strategic (long-term) targets, we think it is better to err on the side of caution, maintaining a neutral position relative to bonds, until the endgame in Europe becomes clearer. Throughout the past year, SEI has been cautious on Europe's prospects; we have favored an investment stance that emphasizes U.S. stocks versus international equities, especially those of the eurozone. The recent European Union (EU) agreement, while a step forward, is not a game changer in our view.

The U.S. economy and financial system remain in fairly decent shape. U.S. equities also are attractively valued following their April/May declines. The backdrop of a modestly expanding economy, historically low interest rates, and moderate earnings growth is a positive one for a continuation of the cyclical bull market. Unfortunately, Europe's problems are piling up fast, creating a level of uncertainty in the near term that is trumping the bullish fundamentals found in the U.S.

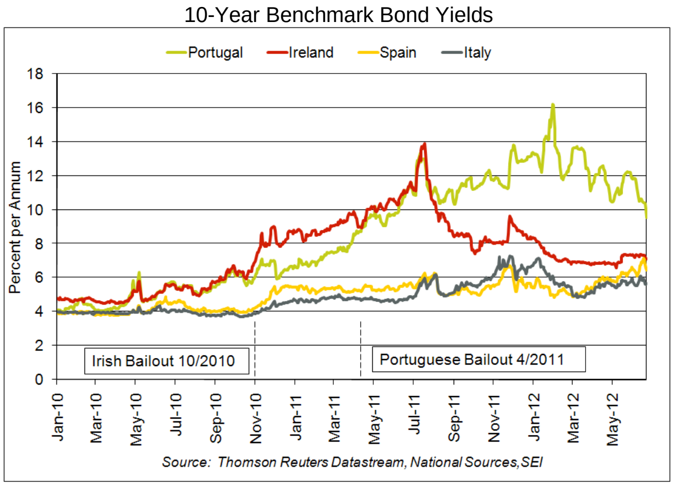
European Fears at the Top of the Charts

"Euphoria," performed by Swedish recording artist Loreen, is the title of one of the most popular songs in Europe this year. But there isn't much euphoria to be found among Europeans as the eurozone's debt crisis takes another turn for the worse.

We thought this issue would be placed on the back burner for a while by the European Central Bank's (ECB) Long Term Refinancing Operation (LTRO). That initiative infused the eurozone's banking system with €1 trillion back in December and February and appeared to be quite successful in achieving its two main objectives. First, it eased an incipient credit crunch brought on by the fleeing of depositors and other investors from the weaker periphery banks. Second, it allowed for a sharp decline in the sovereign bond yields of the periphery countries because banks in Italy, Spain and elsewhere used the cheap LTRO funds to buy the high-yielding debt of their home countries – a form of quantitative easing.

It seems, however, that "solutions" to the European debt crisis become ever more fleeting. The devastating Greek election results of May 6 that brought the radical Syriza Party into prominence kicked off another round of political uncertainty. The political turbulence in Greece, in turn, has raised fears of bank runs and contagion across the periphery, ultimately leading to the announcement in early June of a €100 billion recapitalization of the Spanish banks. As shown in Exhibit 1 on the following page, bond yields in Spain have surged briefly in June toward levels that have precipitated bail-outs in Greece (May 2010), Ireland (October 2010) and Portugal (April 2011).

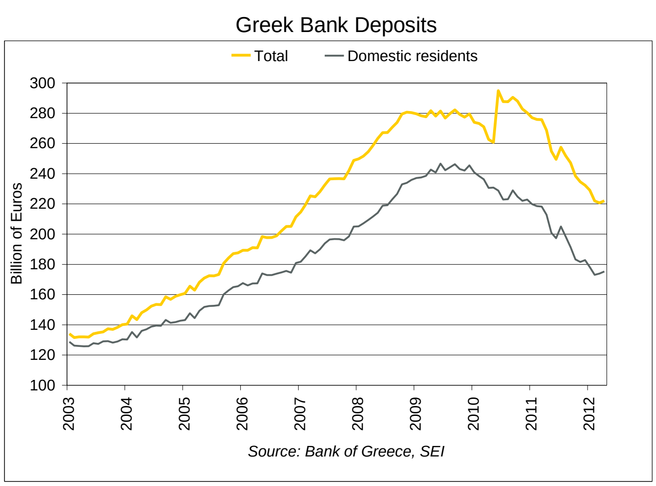
Exhibit 1: Spain in the Cross-Hairs



Source: Thomson Reuters Datastream, National Sources, SEI

The second round of elections held June 17 served to take an immediate Greek exit off the table. In our opinion, however, it merely puts off the day of reckoning. The country's basic problems remain unchanged: (1) it cannot pay back its debt under any conceivable scenario without further restructuring and/or massive and on-going fiscal transfers; and (2) it cannot easily or quickly increase its competitiveness within the confines of the currency union. The political coalition between the New Democracy party and the Panhellenic Socialist Movement party will likely be unstable, made even more fragile by the country's deep recession and social distress. At the very least, one should expect continued outflows of deposits from Greece's banks. These outflows started in earnest two-and-a-half years ago, but have picked up pace in the past two months. Some €80 billion, amounting to 33% of the deposit base, have been pulled out by Greek residents since the start of 2010. Exhibit 2 highlights the trend.

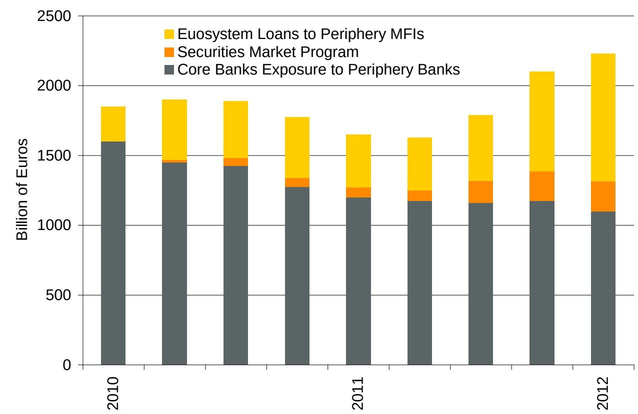
Exhibit 2: Greece Suffers a Run on Its Banks



Source: Bank of Greece, SEI

Spain and Italy, meanwhile, are experiencing severe contagion affects. Not that this is really new – the commercial banks of the core lenders (Germany, France, Belgium and the Netherlands), have been reducing their exposures to the periphery since the second half of 2010. The European Central Bank has been required to step into the breach, putting its balance sheet at risk. But, of course, the creditor countries – with Germany at the top of list – will be the ones that will need to come to the rescue of the ECB if (when?) periphery debt turns sour.

Exhibit 3: The ECB Rushes In Where Banks Fear to Tread



Source: Bloomberg, Credit Suisse, European Central Bank, SEI

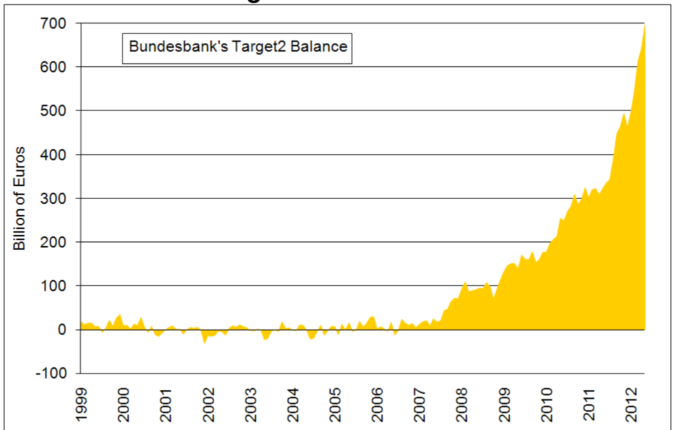
Credit Suisse analysts Christian Schwarz and Matthias Klein recently noted[1] that Germany has already made promises amounting to some 18% of gross domestic product (GDP) backstopping the European Financial Stability Facility, the European Stability Mechanism, the Securities Market Program and the various direct bail-outs of Greece, Ireland and Portugal.

Even more disconcerting, however, is Germany's exposure to the periphery via the so-called Target2 system, Europe's interbank payments system. Up until 2007, credits and debits would net to zero in the normal course of trade between countries. But as the financial crisis progressed in the periphery, funds have shifted away from the banks in those countries and have headed for the safety of Germany and other core creditor countries. This capital flight shows up in the balance sheets of the Bundesbank (Germany's central bank) as a credit and in the national central banks of the periphery as a debit.

[1] Schwarz, Christian and Matthias Klein, "European Crisis: Will Germany Continue to Pay?" Credit Suisse Fixed Income Research, May 23, 2012.

The Bundesbank's claims on the various national central banks of Italy, Spain, Portugal, Ireland and Greece now amount to €700 billion or some 28% of its GDP, as seen in Exhibit 4. These claims could rise to €1 trillion by year-end (the other creditor countries have a credit balance of an additional €300 billion). As the financial crisis in Europe deepens, Germany's exposure is actually increasing even though its commercial banks are reducing their claims on the periphery.

Exhibit 4: A Fat Target



Source: Deutche Bundesbank, SEI

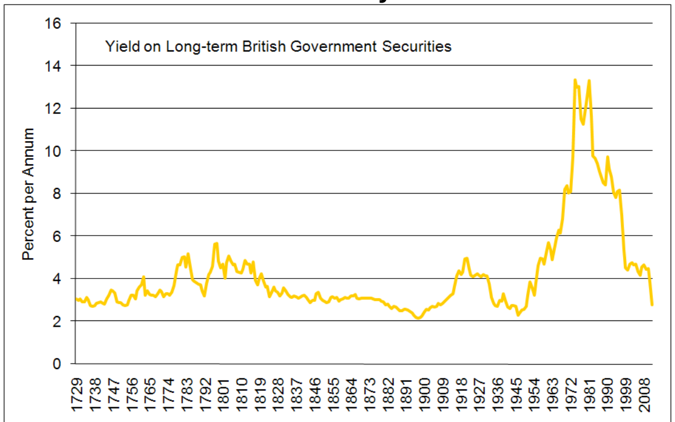
These Target2 imbalances do not show up on the balance sheet of the ECB itself because the intra-system debits and credits between the member central banks mostly offset each other. However, in the event of a Greek exit from the eurozone and a subsequent banking collapse, it will be the responsibility of all the individual-country central banks to cover their share of the ECB's losses. Although a national central bank's risk is legally limited to its share of the ECB's paid-in capital (amounting to 27% in the case of the German Bundesbank), there are concerns that other central banks in the periphery will not have the ability to cover their share of the losses. This is the sort of counterparty risk that proved so devastating in the aftermath of the Lehman crisis in the fall of 2008.

While all this is scary-sounding stuff, we think that the economic impact might not be as horrendous as many commentators make it out to be. In the event of a full break-up of the eurozone, there likely would be a pooling of Target2 assets held by the debtor countries, which would be handed over to the Target2 creditors. Admittedly, the economic value of those periphery-held assets could be far less than their face value since these central banks would settle up in depreciated currencies.

Keep in mind, though, that all this is at the central-bank, not commercial-bank, level. To take the most extreme case, let's assume the Bundesbank falls into a negative equity position by marking down its assets. As a newly independent central bank, it could massively expand its balance sheet and buy assets (e.g., government bonds) that earn interest well above its liabilities (e.g. zero-yielding banknotes).[2] Over time, the hole in the balance sheet will be repaired through the profits that result. Of course, this solution comes at a price. First, it would reduce the revenues that normally accrue to the government, thereby complicating the conduct of fiscal policy. Second, it raises the odds of an inflationary outcome. Even the Germans probably will accept this risk, however, if the alternative is a severe recession that could be worse than the 2008-09 experience. As an added benefit, adopting a money-printing strategy would likely moderate the sharp appreciation of the new deutschemark that would otherwise occur.

The European debt crisis has reached the point where serious thought needs to be given to such once-unthinkable break-up scenarios. This is the reason behind the extraordinary flight to perceived safe-haven investments. German bund yields recently fell to a 90-year low. British 20-year gilts are near a 300-year low, as shown in Exhibit 5. U.S. bonds also are very close to all-time lows in yield. Adjusted for inflation, yields are firmly in negative territory. If there's a bull market anywhere, it is in fear. If there are asset bubbles to be found, it is in the sovereign debt of the safe-haven countries.

Exhibit 5: U.K. Gilts Near 300-year Lows



Source: Bank of England, MeasuringWorth, SEI

[2] Davies, Gavyn. "ECB Liquidity Is Not a Free Lunch," Financial Times, March 4, 2012

Summertime, But the Livin' Ain't Easy

The on-going turmoil in Europe's banking system is having a predictably negative impact on the eurozone economy and beyond. Loans to businesses and households in the eurozone have not grown at all in the past year, and are contracting outright in the weaker economies. By contrast, commercial and industrial loans in the U.S. have expanded by some 12% over the past 12 months, and consumer credit has managed a mid-single-digit gain. Overall eurozone GDP is flat, by contrast, while the year-to-year declines in the periphery seem to be accelerating.

Germany is still the strongest economy in Europe, but even that country is feeling the downward tug from the rest of the eurozone. Inflation-adjusted GDP has eased to an anemic 1.2% year-over-year rate, while industrial output has registered a 0.7% decline through the 12-month period ended in April. Additionally, the Purchasing Managers Index is in recession territory, and the Organisation for Economic Co-operation and Development's Index of Economic Indicators is suggesting that the pain will continue. Since 60% of German exports are shipped to the rest of Europe (including non-eurozone members), and total exports amount to nearly half of Germany's GDP, it should be no surprise that the economy's manufacturing sector is starting to struggle.

Meanwhile, the U.K. economy has felt the full force of the slumping eurozone, coming on top of home-grown fiscal austerity. The year-on-year gain in GDP has been tailing off steadily for the past two years, edging into negative territory in the first quarter. The Bank of England has held its policy rate at a very low 0.5%, since early 2009. It has also engaged in periodic quantitative easing efforts and will continue to do so. In the days before the Greek election, the government committed itself to additional liquidity injections and a targeted fiscal stimulus to offset the deflationary impulses emanating from the Continent. Fortunately, inflation is finally ebbing from the stubbornly high rates of last year. The year-on-year change is down to 2.8%, versus a peak of 5% in the third quarter of last year. This provides the needed flexibility to respond more forcefully to the slowdown.

In similar fashion, emerging markets have been going through something of a soft patch, partially owing to a triple dose of trouble from Europe. First, direct trade with Europe has been hit hard. Second, trade among emerging countries has suffered as exporters to Europe, especially China, reduce the import of raw materials and intermediate goods. Third, trade credit has become tighter as stressed commercial banks in Europe cut back their exposures, with the sharpest impact felt in Asia.

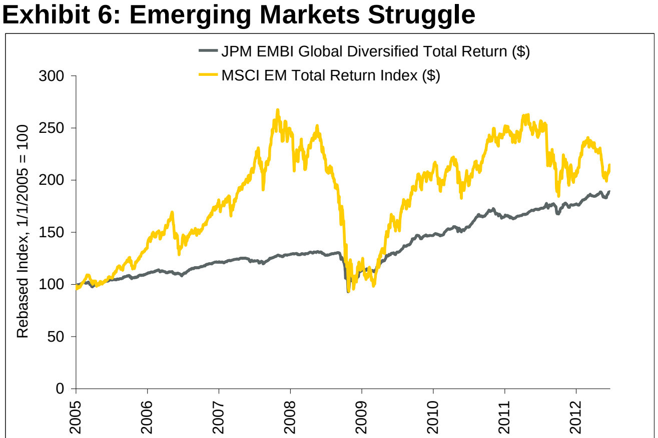
In Asia, China and India still enjoy relatively strong growth in GDP of 8.1% and 5.3%, respectively. But both economies are slowing from much higher rates of growth. India's inflation remains very high, rising 10.2% over the past year. This may constrain the government's ability to stimulate the economy. The Reserve Bank of India (RBI) recently surprised observers by refraining from cutting its policy interest rate; at about 8%, yields are well below the inflation rate. Pressure remains on the RBI to pursue monetary expansion, however. Industrial production is weak and the trade balance has deteriorated sharply over the past 18 months.

China, by contrast, is in a better position to respond with stimulus measures. Its headline inflation rate has decelerated to 3%, and may continue to ease in response to the sharp decline in global commodity prices. The Bank of China has lowered its policy interest rate twice this year. This follows several cuts in banks' required reserve ratios and underscores the concerns that government authorities in China have regarding the pace of growth.

Brazil's GDP, meanwhile, has grown only 0.8% in the year through March, and industrial production has dropped almost 3% through April. The unemployment rate has popped higher in recent months as well, rising to 6% from a year-end 2011 low of less than 5%. Consumer spending, which seemed to be defying the slowdown in the industrial output earlier this year, has registered a sharp slowing of growth in recent months.

As a result of this uneven economic performance, investors have faced severe challenges in emerging markets during the past quarter. Not only have they had to grapple with slowing growth, but they also had to deal with severe declines in the local currency against the dollar. The MSCI Emerging Markets total return index, for example, is down about 8.8% in dollar terms. By contrast, the JP Morgan EMBI Global Diversified Index, a dollar-based fixed-income benchmark, has gained 2.8% over this period, as seen in Exhibit 6.

Exhibit 6: Emerging Markets Struggle



Source: JP Morgan, MSCI, SEI

Emerging-market equities are starting to look cheap on the basis of earnings, cash flow and dividend yields. The sharp currency depreciation experienced by many emerging countries, combined with aggressive monetary policy actions, should provide a boost to these economies in the months ahead. When the “risk-on” trade comes back into vogue, we think emerging-market equity will be a major beneficiary.

Trying to Avoid a Wipeout While Surfin’ USA

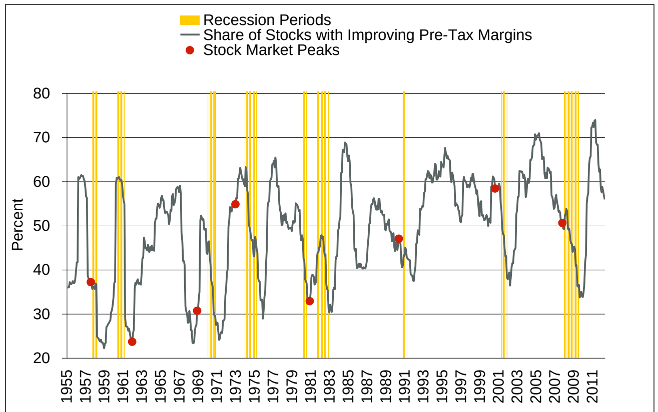
We keep saying that the U.S. is the best house in a bad neighborhood. That still seems to be true, although it does appear that the economy has entered another soft patch. On the positive side, employment in the private sector continues to edge higher. Wages and salaries also continue to advance, gaining 3.4% in the past 12 months. Although far from ebullient, consumer confidence has jumped significantly from the lows of last October. Finally, nominal-dollar retail sales have advanced at more than a 5% clip year over year through May despite two consecutive monthly declines, while industrial production is enjoying one of its best expansions in the past 30 years.

As we mentioned above, the U.S. banking system is certainly on sounder footing than Europe’s, allowing for the resumption of credit growth to both businesses and consumers. Since households have deleveraged to the point where debt service as a percentage of disposable income is back to the level of the early 1990s, we view the upswing in consumer credit trends as a good sign.

We also are seeing broad-based evidence of a modest revival in the housing sector. Home sales and new-home construction have hit bottom, in our opinion. We do not expect the housing sector to be a significant contributor to growth anytime soon. However, it will no longer be detracting from growth.

In all, we believe the economy will grow at an annual rate about 2% to 3% over the next 12 to 24 months, although it may proceed at a somewhat slower pace in the very near term. Combined with an inflation rate in the same range, we are penciling growth in nominal GDP of about 5%. Corporate revenues and earnings should grow at a slightly faster rate, as U.S. businesses benefit from productivity gains and growth in emerging markets. Fears that the recent slippage in profit margins will soon lead to a peak in stock prices are not borne out by history. A recent analysis by quantitative strategist Michael Goldstein of Empirical Partners, seen in Exhibit 7, shows that profit margins tend to top out roughly two or three years before the peak in the stock market and the economy. Unless the economy is hit by a severe shock, it is likely equities will continue to trend higher well into 2013, if not beyond.

Exhibit 7: Profit Margins Have Peaked, the Market Hasn’t



Source: Empirical Partners, National Bureau of Economic Research, SEI

The possibility of a severe shock cannot be lightly dismissed, however. A sudden break-up of the eurozone would be a catastrophic event, perhaps comparable in impact to the 2007-08 debt debacle. A sharp decline in global trade and financial contagion would be hard to avoid. We do not expect the worst-case scenarios to come to pass, however. We expect Europe to continue to muddle through. It’s also our belief that the direct impact of Europe’s recession on U.S. economic activity should be limited. U.S. commercial banks have reduced their exposures to their European counterparts, particularly in the periphery, as the eurozone has gone from bad to worse. In addition, U.S. exports of goods to the euro area amount to less than 2% of GDP. In a muddling-through scenario, an economic decoupling of the U.S. economy is not that far-fetched. Trade with Canada, Mexico, China and the Southeast Asian countries – economies that have much stronger growth potential – should offset the weakening of trade ties with Europe.

Of course, the U.S. has its own home-grown problems that are impeding its economic performance. Businesses and households are facing a raft of issues. The so-called fiscal cliff – the combination of tax increases and spending cuts set to kick in on January 1 – is a case in point. The Congressional Budget Office estimates that the expirations of (1) the Bush-era tax cuts, (2) the Alternative Minimum Tax fix, (3) the Social Security payroll tax cut, and (4) extended unemployment insurance, as well as (5) the automatic spending cuts to defense and non-defense discretionary programs, will result in a cumulative fiscal contraction of some 3.6% of GDP -- enough to push the economy into outright recession during the first half of 2013. Exhibit 8 on the following page provides a closer look at the situation.

Exhibit 8: A Cliff Hanger

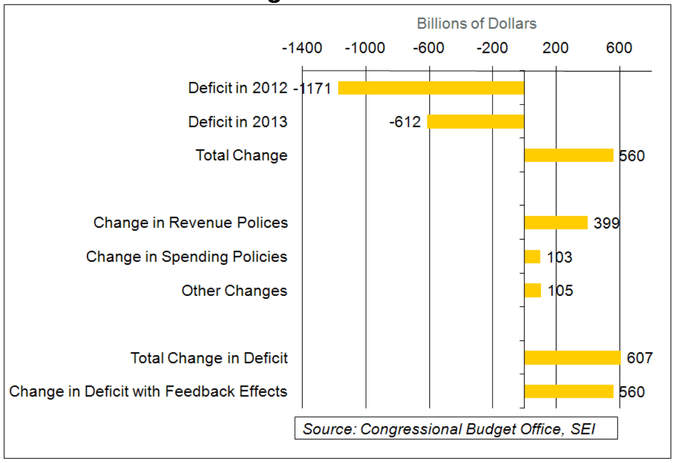
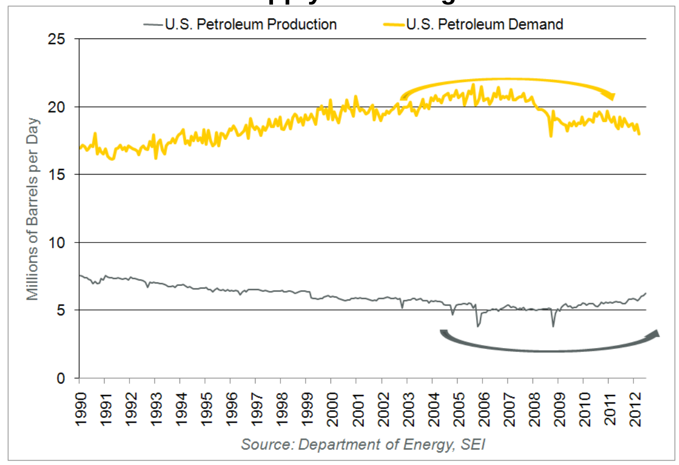


Exhibit 9: Crude Oil: The Gap between U.S. Demand and Supply Is Closing



Obviously, even the most stubbornly partisan member of Congress on either side of the aisle does not want to see this potential danger turn into a reality. Unless there is a major financial-market meltdown, however, we see little incentive for the politicians to agree to anything until after the elections in November. The most one can expect is a pre-election agreement to delay any automatic tax hikes or spending cuts for three or six months. This kicking of the can down the road will do nothing for confidence. Businesses will not hire or invest aggressively as long as the uncertainty lasts.

The outlook for U.S. fiscal policy is completely dependent on the outcome of the election. Our working assumption is that the Executive and Legislative branches will remain divided, making compromise hard to achieve. In contrast, the direction of monetary policy is clear. The Fed is prepared to do what it takes to keep interest rates low and the economy afloat. It has already announced its intention to extend Operation Twist through the end of the year, with the objective of buying $267 billion of Treasury bonds in the 6-to-30 year maturity range and selling bills and notes up to a maturity of three years. This is expected to have only a modest impact – yields at the long end of the curve are already near record lows as we noted earlier.

In the event of a global financial crisis, however, the central bank has clearly signaled that it will reinstitute an aggressive quantitative easing program. This decision has been made easier by the abrupt decline in commodity prices, especially for energy. Just three months ago, we were fretful that rising oil prices would keep CPI inflation higher than expected. Indeed, escalating tensions over Iran's nuclear program raised the possibility of a damaging surge in oil prices to $200 per barrel on the heels of an Israeli pre-emptive strike. Instead of a price spike, oil prices have collapsed by more than 20%. Rapid oil production gains by Saudi Arabia, Iraq and – wonder of wonders – the U.S. have changed the world oil balance in dramatic fashion.

To be sure, it's sometimes a struggle to be optimistic while watching the wrangling in Europe or worrying about a pending fiscal crunch in the U.S. One merely needs to recall the events of last summer, when the fight over the U.S. debt ceiling and the subsequent downgrade of the government's debt rating by Standard and Poor's resulted in waterfall declines of risky assets around the world. Yet, U.S. equities have managed to rebound nicely in recent weeks and are again approaching the previous highs of the year. The U.S. economy's underlying resiliency and the Fed's aggressively easy policy stance should not be ignored.

Navigating the Markets: No Summer Breeze

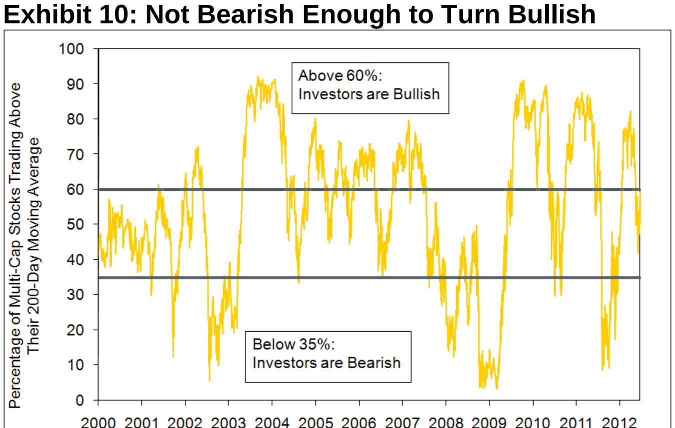
Once again, the investment environment has turned rather challenging. Market participants are facing a raft of uncertainties. Will the favorable market response to the latest European agreement last any longer than prior ones? How serious is the U.S. soft patch? Who will be elected in November? Will Congress jump off the fiscal cliff at the beginning of 2013? Not only is it hard to guess the answers to these questions, but it's just as hard to gauge the reaction of the markets.

There has already been a significant risk-off response in the credit markets and in European equity markets. Emerging markets also have sustained a sharp correction in recent months. We emphasize, however, the word "correction." Generally speaking, the price declines logged over the past three months are not as severe as those that took place in the middle of last year. And, of course, they pale against the historic bear market plunge seen in 2007-2009.

We expect markets to remain choppy and news-driven going into the November elections. With the European Union economic summit out of the way, we do not expect any more policy surprises until after Europe's leaders come back from their vacations. In the meantime, investor attention will shift toward the U.S., with the focus on polling data as much as on economic data.

The move into safe-haven sovereign bonds (U.S. Treasurys, German bunds, U.K. gilts) looks extreme. Stock markets are attractively valued, but are not the bargains they were late last year. At this point, investors are fearful but they are not panicky. We will consider increasing our equity exposure when pessimism gets a bit deeper and selling pressure more intense. We would note that 60% of the multi-cap stocks followed by Ned Davis Research are trading above their 200-day moving average, up from a recent low of 45%, as highlighted in Exhibit 10. This is not capitulative behavior. Last August and September saw readings in the single digits, providing a hint that the selling pressure was reaching a climax. Even in the type of garden-variety correction we are expecting in U.S. equities, the proportion of stocks trading above the 200-day moving average typically reaches a level of 35% or less. That said, the U.S. stock market appears to be a better bet than most other developed markets.

Exhibit 10: Not Bearish Enough to Turn Bullish



Source: Ned Davis Research, SEI

Where We Stand

- SEI continues to hold a neutral view on stocks versus bonds. The potential for big surprises – either to the downside (e.g. further economic weakness, the crumbling of the eurozone) or the upside (e.g. more forceful actions in Europe, QE or a breaking of the fiscal logjam in the U.S.) sit side by side. We would be inclined to over-weight equities if the markets weaken materially further. This assumes: (1) the soft patch in the U.S. economy proves temporary once again; (2) Europe muddles through into 2013 without a major break-up; and (3) the currency depreciation and pro-cyclical monetary policies in China and other emerging economies start to bear fruit going into year end. In some mandates, we currently lean defensively within equities by overweighting lower-beta sectors (utilities, consumer staples and healthcare).

- Momentum trends continue to favor U.S. equities versus international, particularly against Europe and the eurozone. We recognize that this trend has been in place for more than a year. Recession, debt traps and the possibility of a eurozone break-up have caused European equities to weaken to an extreme extent. We are skeptical that the EU agreement at quarter's end will lead to a major reversal, the initial positive response notwithstanding. We look for the cycle of panic, government response, relief and panic to continue in European markets.

- We are underweight eurozone equities, and/or short the euro against the dollar, in portfolios where we have the ability to implement short-term positions versus our strategic asset allocation targets. We think the ECB will continue to inflate its balance sheet in an aggressive fashion in an effort to maintain the liquidity of the peripheral banking systems. We have just seen a decline in the ECB's policy rate from 1% to 0.75%. These actions, along with a structual economic growth rate in favor of the U.S., should lead to more downward pressure on the euro against the greenback in the coming months.

- We also have a bias toward U.S. high-yield debt and other corporate credits versus Treasurys and the sovereign debt of other countries. Investor demand remains buoyant for higher-yielding assets because central-bank policies have compressed yields to record-low levels around the globe. Issuers also remain in good shape, keeping default rates at low levels. In the near term, worries about the economy could cause some widening in spreads versus Treasurys. We would view this as a buying opportunity.