Economic Outlook

Second Quarter 2013

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Reading the Taper

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- The increase in volatility in both stocks and bonds is unnerving but opens up investment opportunities.
- It provides a catalyst for all asset managers to reassess their basic assumptions and determine where the investment opportunities now lie.
- Our general optimism on the outlook for equities and our more cautious view regarding the long-term trend for bonds remains intact.

The past several weeks have been tough for investors, as markets across asset classes and geographies came under pressure. Although a pullback in equity prices was long overdue—most developed market stock markets had climbed sharply since late last year—it never feels good when a correction finally comes. From the May 21-22 peak through the month of June, developed-market equities (as measured by the MSCI World Total Return Index) have fallen about 6%, with the U.S. falling a bit less than the average. The Japanese stock market has been the most notable casualty, diving about 20% before rebounding sharply. Emerging-market equities, meanwhile, have also taken a severe drubbing (mostly undoing a strong rally that had taken hold in April and early May). Brazil, the Philippines, Egypt, Indonesia, Thailand and Turkey are some of the more popular emerging equity markets to sustain double-digit declines.

Of course, some perspective is useful. Even after the lumps taken in recent weeks, developed-market equities are still up for the year—about 12%, using the MSCI World Total Return Index as the yardstick. Japan, despite its recent pummeling, is still up more than 34% year to date in terms of local currency total return. Emerging markets, on the other hand, have been laggards through most of the year and are now around their 2013 lows.

Fixed-income markets have not been spared in the recent correction, which is a big change from the usual risk-off response. The Barclays U.S. Aggregate Total Return Index, for example, has fallen almost 4% from its May peak, a performance that is only slightly better than U.S. equities over the same time period, and the benchmark is now in the red for the year. Yields on government 10-year benchmark bonds have climbed as much as 60-to-90 basis points[1] for safe-haven countries, to their highest levels in a year in most cases. Periphery European bonds and emerging-market debt have been hit especially hard. Interestingly, Japanese benchmark bonds, which roiled international markets when yields briefly approached 1%, have fallen back to 0.88%—the same level where they started the year.

What's particularly striking is the fact that bond yields have moved higher at a time when inflation expectations (and actual inflation) have eased significantly in the U.S. and elsewhere. Even as nominal bond yields have been popping higher, inflation expectations have fallen to their lowest levels in a year. In other words, real yields, which reflect nominal yields minus expected inflation, are being dragged higher in a hurry. Yields on 10-year Treasury Inflation Protected Securities (TIPs) recently hit positive 0.75%. They were negative 0.65% in early May, and hit their low point of negative 0.90% in December. We believe this stunning climb in real yields is the first phase of a longer trend toward the general normalization of fixed-income yields, which have been kept at artificially low levels in recent years by central-bank actions. The truly amazing fact is that TIPs yields turned negative in the first place in mid-2011 and proceeded to decline from there. During the 2003-2007 expansion, by contrast, real yields traded between 1% and 2%. This restoration of value that we are seeing probably has more room to go, although the path toward more normal yields will certainly experience detours (i.e., price rallies) along the way.

We'll Have Fun, Fun, Fun 'Til Bernanke Sells His T-Bonds Away

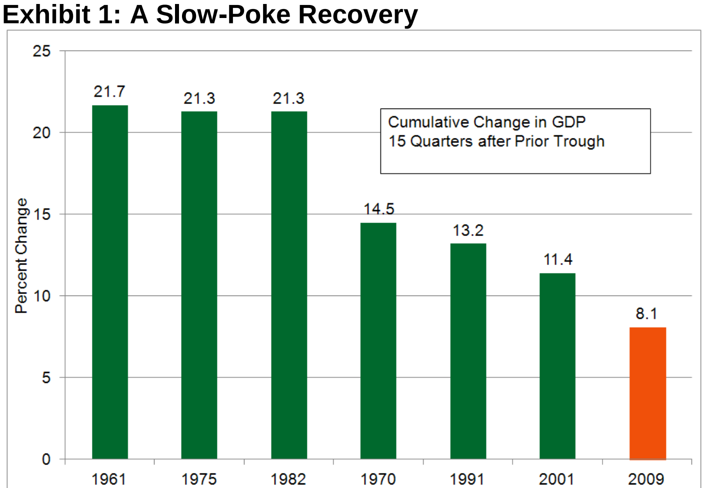
Market pundits have identified a few catalysts behind the global selloff. One was the release of the Federal Open Market Committee (FOMC) minutes on May 22 for the meeting held three weeks earlier. Those minutes raised the possibility that the central bank would start to reduce its purchases of Treasury bonds and mortgage-backed securities (MBS) within the next quarter or two. To us,

[1] One basis point equals 0.01%.

investors' fears surrounding the economic impact of an early exit from the Fed's extraordinary easing efforts appear to be overdone.

Although the U.S. economy is on the mend, growth remains remarkably subdued almost four years after the recession ended. The 8% cumulative gain in inflation-adjusted gross domestic product (GDP) is the weakest on record in the post-World War II period, as Exhibit 1 shows. This recovery is even more disappointing when you consider that the recession preceding it was the worst downturn since the Great Depression of the 1930s. The absence of a V-shaped recovery (an economy that rebounds as quickly as it fell) suggests that inflation should remain subdued for a few more years, even if the Fed continues to rapidly expand its balance sheet.

Exhibit 1: A Slow-Poke Recovery

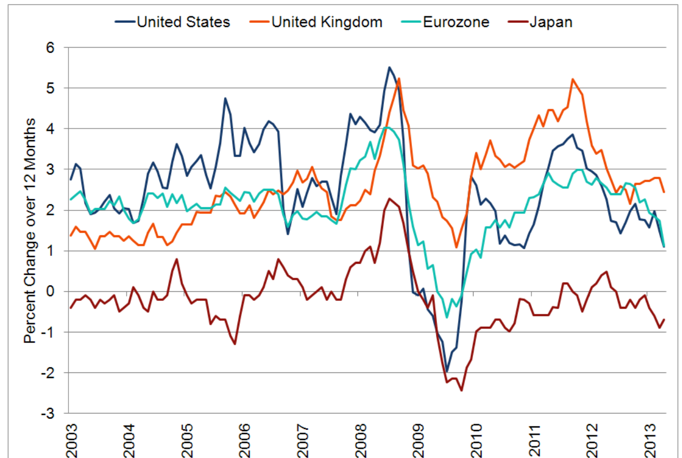


Source: Bureau of Economic Analysis, National Bureau of Economic Research, Yardeni Research, SEI

It is worth reiterating the main economic themes of recent years that will likely continue to influence the conduct of monetary policy. First, although U.S. economic activity is advancing, it is doing so at a sluggish and unsatisfying pace. To be sure, housing and consumer durables, two highly cyclical and interest rate-sensitive areas, are posting solid, double-digit gains. The level of activity for both, however, remains well below their previous cyclical peaks. Housing starts, for example, have doubled from their lows to almost one million units at a seasonally adjusted annual rate. But they are still less than halfway to where they were in 2005. At 15 million units annually, auto sales are 66% higher than they were in early 2009, but are still almost 15% below the pace that prevailed from 1999 through 2005.

Second, as we seem to note almost every quarter, the U.S. is further along the path of recovery than most other countries. There has still been no generalized global upswing in economic activity. On the contrary, weak aggregate demand in Europe has fed into slower Chinese export growth. This, in turn, depresses trade with other export-oriented emerging economies. The result has been downward pressure on industrial commodity prices and the slowest pace of global GDP growth since 2009. This has helped push inflation toward cyclical lows throughout the world. In the U.S., inflation has fallen about one percentage point below the central bank's stated target. This same situation prevails in the eurozone and Japan (Exhibit 2).

Exhibit 2: Inflation Ebbs around the World



Source: OECD, SEI

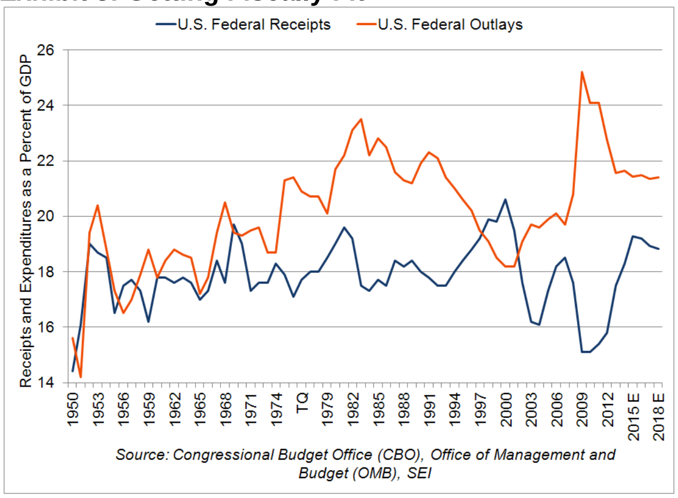
Third, countries burdened with too much debt continue to impose (or have imposed upon them) austerity measures that reduce government expenditures and raise taxes. The Europeans, of course, have been enduring this unremitting grind for the past four years. The need to cut government spending and payrolls has restrained the region's recovery from the 2007-2009 financial crisis, throwing several countries in the periphery and the core back into recession for the second or even third time.

The United States, by contrast, has managed to avoid tipping back into recession, although there have been soft patches and growth scares along the way. One ironic reason for the better economic performance in the U.S. is political gridlock at the federal (central government) level. While state and local governments were cutting deeply into services and headcount, Washington continued to run outsized deficits. The squeeze on the overall economy caused by retrenching consumers and local governments was therefore somewhat offset by countercyclical government policy at the national level.

Fiscal austerity at the federal level is starting to take hold, however. The payroll and income tax increases imposed at the start of the year, the winding down of defense spending in the aftermath of the wars in Iraq and Afghanistan, and the spending sequester that is now just beginning to bite are leading to a relatively rapid decline in the U.S. deficit. The Congressional Budget Office sharply reduced its estimate of federal government red ink for the 2013 fiscal year by $185 billion in May from the prior forecast made in February. Tax revenues have taken a sharp upward turn, while overall spending continues to flat-line. This is expected to bring the federal budget deficit to

4% of GDP, the lowest percentage in five years. State and local governments are also reporting upward revisions in tax revenues, with California being a notable example. That state expects a modest surplus for the fiscal year ended June 30, with surpluses increasing in size over the next few years. Just a few years ago, its annual deficit hit $30 billion.

Exhibit 3: Getting Fiscally Fit



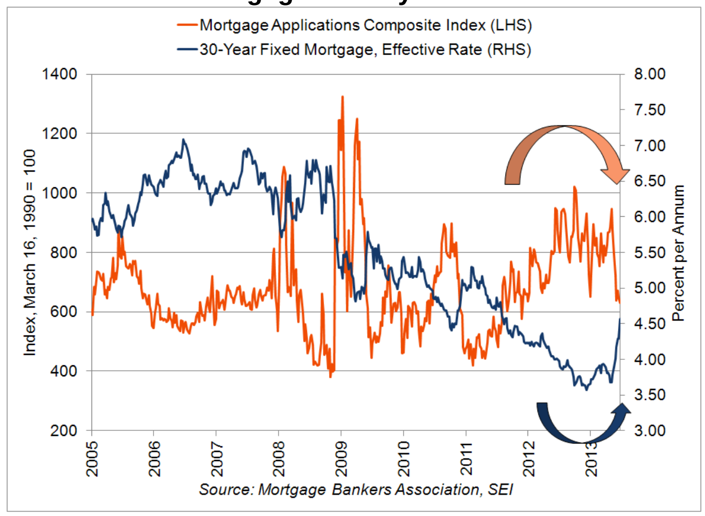
Source: Congressional Budget Office (CBO), Office of Management and Budget (OMB), SEI

Of course, big states like California still face longer-term fiscal pressures owing to future pension and healthcare liabilities that are badly underfunded. They will eventually face the same unhappy choices that the welfare states of Europe are facing now—a combination of benefit cuts and tax increases that will likely create economic and political stress—but that is a future challenge. In the near-term, optimism is growing that the worst of the recession at both the state and local government levels is coming to an end.

Finally, the reduction in the federal deficit comes at a time when the Federal Reserve is buying $45 billion in Treasury-bonds each month (along with $40 billion of mortgage-backed securities). This means the central bank is buying up the majority of marketable securities issued by the U.S. government. The Fed could be purchasing as much as 80% of net Treasury issuance by year end. This should keep a lid on how high T-bond yields can rise in the near term, even if the Fed begins to reduce the pace of its purchases. It should also continue to force the public into other income-yielding fixed-income and equity assets. As long as the Fed is such a presence in the market, it is unlikely that yields on 10-year Treasurys will move dramatically beyond the recent high of 2.65%. The deceleration in the inflation rate, both headline and excluding food and energy, should also lead to a more leisurely exit than investors have recently priced in.

The shift toward modest austerity in the U.S. government's finances will probably give some pause to decision-makers at the Fed. Do they really want to dial back their quantitative easing (QE) policy dramatically and risk a sharp rise in interest rates that would disrupt the recovery in housing? Although an exit from QE and a (much later) move away from zero short-term interest rates should occur in response to sustained economic improvement, the recovery to date still seems rather fragile. We note that there already has been a quick drop in mortgage refinancing in response to the recent turbulence in the bond market, as the rate on 30-year fixed mortgages popped above the 4.50% mark (Exhibit 4).

Exhibit 4: U.S. Mortgage Activity



Source: Mortgage Bankers Association, SEI

SEI's fixed-income managers actually used the volatility in the bond market to opportunistically gain additional credit spread exposure (especially in agency mortgage-backed securities) and to extend durations modestly (although they are still short of their benchmark). Other fixed-income themes remain the same, with higher-than-benchmark exposures to financial credits and non-agency MBS.

Perhaps the FOMC meeting minutes were a trial balloon to test market reaction to the idea of weaning investors off of QE. If so, that balloon has landed with a thud, strengthening the hand of Chairman Bernanke and the other doves within the central bank. Keep in mind the Chairman's obsession over avoiding the mistakes of the past; the Fed stayed too tight for too long during the early years of the Great Depression, and then failed to aggressively offset the tremendous fiscal tightening that occurred in 1937-1938.

Bernanke's determination to maintain accommodative monetary policy for longer than anyone might imagine is reinforced by observing Japan's sad experience with deflation over the past 23 years, and more recently by the actions of the European Central Bank that are surely delaying the start of a sustainable European recovery. In all, we think Treasury yields have entered a higher trading range of 2.25% to 2.75%. While fixed-income markets may be slipping into a longer-term secular bear market, we expect to see a rally develop from the deeply oversold conditions that currently exist.

Ja-Panic Attack

Another factor behind the correction in global equity markets is the rapid turn for the worse of investor opinion on Japan. We already noted that the country's stock market fell as much as 20% from mid-May to late June. We figure this dramatic activity was mostly the result of the unwinding of profitable long-equity/short-yen positions: The yen appreciated sharply against the dollar—almost 10%—concurrent with the stock market's slide. The proximate cause of the selloff was disappointment that the Bank of Japan (BOJ) did not get even more aggressive to keep the yen from appreciating. In addition, there remains intense skepticism that Japan can ever get out of its deflationary ditch. To top it off, Prime Minister Shinzo Abe's unveiling of structural reform initiatives was less than inspiring.

In our active asset allocation strategies, we were fortunate to unwind our overweight Japan equity/underweight European ex-U.K. equity position in early April. We did, however, replace the long Japanese equity position with an outright short of the yen. This worked well out of the gate but turned against us as other investors unwound their currency-hedged positions in the equity market. At this point, we maintain our bearish yen position in the belief that the BOJ is determined to pursue a monetary inflation aimed at jumpstarting economic growth and boosting prices. This should ultimately weaken its currency to ¥110 and beyond, in our opinion.

The BOJ's decision to sit on its hands and not actively fight the yen's recent appreciation strikes us as a sensible tactic. The last thing BOJ Governor Haruhiko Kuroda wants to do is make a show of strength but be ultimately overrun by market participants. It's best to let the fast money flow out before trying to push the currency in the desired direction. In the longer run, we do not think it will pay to fight the BOJ or any other central bank prepared to be "credibly irresponsible," to quote economist and *New York Times* columnist Paul Krugman. One thing is for sure—an appreciating yen is not part of the Japanese game plan. While the BOJ and the Abe government will never say that yen weakness is a policy goal, it is certainly a by-product of the monetary and fiscal policies being pursued to end deflation.

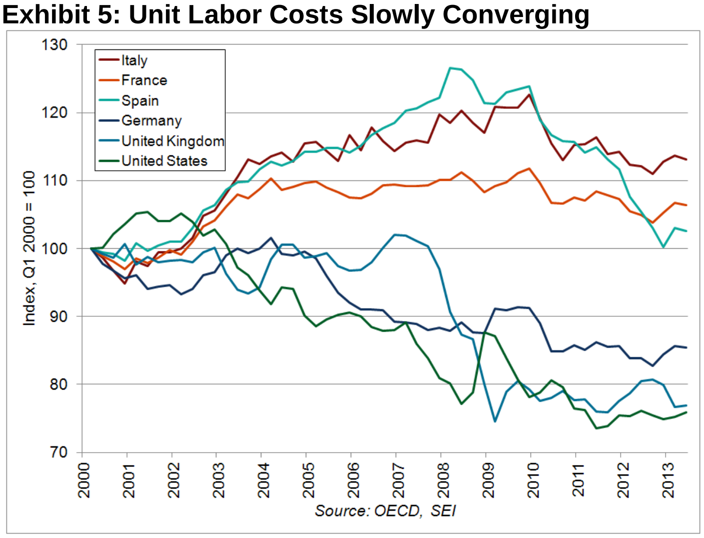
We expect the Abe government to up the ante on its reform initiatives once the Upper House elections are safely out of the way in July 21. To be sure, Mr. Abe is fighting an uphill battle when it comes to pushing against the entrenched rural/agricultural and corporate interests that have supported the Liberal Democratic Party over the decades. But then who would have thought Margaret Thatcher or Ronald Reagan or Luiz Inacio Lula da Silva would have had the ability to change the U.K., U.S. and Brazil, respectively, as dramatically as they did? Granted, Japan's demographic headwind is formidable, and its debt burden appears fiscally unsustainable. But these very challenges are the ones that give urgency to the need for far-ranging reforms. Investors obviously still have low expectations of success. We also have our doubts about whether the Japanese can turn their country around. At this point, we fully expect the yen to depreciate, and this should be associated with a rally in Japanese equities. Whatever happens over the next few years, there is no denying that Japan has become a most interesting place for economists and investors.

Draghi: The Lone Optimist

Like Europe, Japan is challenged by recession, debt and demographics. Unlike Europe, Japan is taking extreme steps to do something about the situation. Europe seems to be sleepwalking through its problems. Unemployment in the eurozone, for example, hit an all-time high of 12.2% in April. Greece and Spain continue to slog through depression-like conditions, with total jobless rates around 27% and youth unemployment at 60%. Eleven of 17 countries have recorded GDP declines over the past year. Yet, at his recent press conferences, European Central Bank (ECB) chief Mario Draghi seems optimistic that Europe is on the upswing.

We really don't see it. When observers express optimism about the trends in Europe, it is usually in reference to the region's problems getting worse less quickly. We will concede that some progress is being made, but at a tremendous cost in unemployment and economic decline. The deep downturns in the periphery have forced wages down, and labor market reforms are pushing productivity in the right direction. Competitiveness in the periphery is improving, as measured by the trend in unit labor costs. But this narrowing trend must go a long way before countries like Spain and Italy get back to the relative positions they enjoyed versus Germany, the United Kingdom and the United States, as seen in Exhibit 5.

Exhibit 5: Unit Labor Costs Slowly Converging

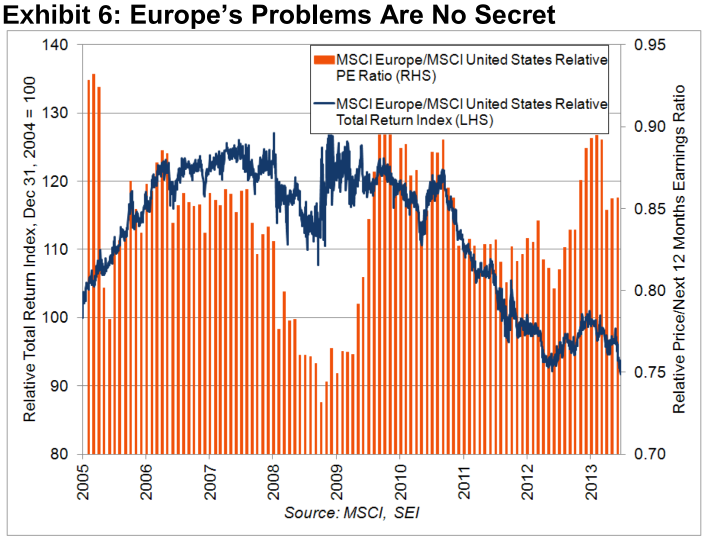


In addition, primary budget deficits (which exclude interest payments) have narrowed, or even moved into surplus. However, recessions and deflation have limited the improvement in debt-to-GDP ratios in the hardest-hit countries. First-quarter GDP fell 0.2% on a year-over-year basis, although the monthly evidence suggests a move toward minimal growth is possible in the second quarter for the eurozone as a whole.

Greece, Portugal, Italy, Spain, Finland and the Netherlands still appear to be in full-blown recessions, and most of the other developed countries in Europe appear to be flip-flopping between small declines and small increases, depending on the quarter. At this point among developed economies in Europe, the United Kingdom seems most likely to post modest growth on par with the U.S. The two main reasons are that the Bank of England is not the ECB, and the Cameron government will likely ease off on fiscal austerity as the 2015 parliamentary elections come into view.

While we recognize that domestic activity does not drive Europe's stock markets (which are dominated by export champions), we think Europe's poor economic outlook will continue to limit the region's equity performance relative to the U.S., as shown in Exhibit 6. Europe's stock market has skidded sharply versus the U.S. in recent years, raising the possibility of a sharp reversion to the mean. In fact, the second half of 2012 provided such an episode, as worries about a eurozone breakup eased. Note, however, that Europe's relative valuation against the U.S. on estimated 12-month earnings still does not appear unduly depressed versus its 10-year history. Europe operates under a variety of well recognized disadvantages vis-à-vis the U.S.—a poorly performing banking system, much higher energy costs, less economic flexibility, etc.

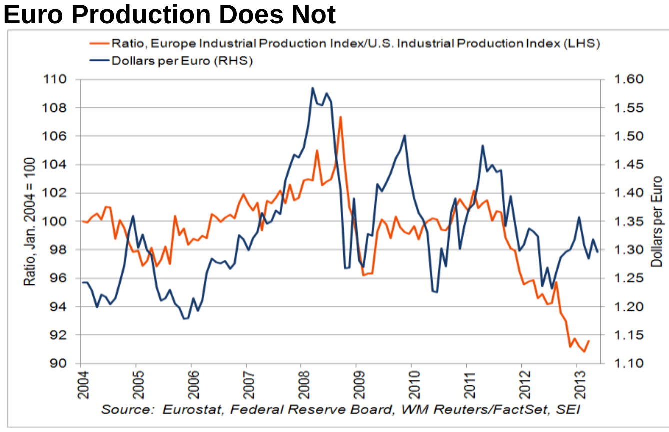
Exhibit 6: Europe's Problems Are No Secret



At this point, we are neutral on Europe's equity market versus other developed-country stock markets. We believe betting against an overvalued common currency is the most attractive investment theme. The euro, of course, strengthened significantly between the third week of May until the market turbulence that hit four weeks later. The bullish arguments in favor of euro appreciation include: (1) a big surplus in the region's current account, driven chiefly by Germany and the Netherlands; (2) the ebbing of investor fears that the eurozone would break up; and, most importantly, (3) a monetary policy that is less expansionary than almost anywhere else. As we noted in last quarter's report, the ECB has been very slow to counter the shrinkage of its balance sheet.

We believe, however, that pressure is intensifying for less austerity and more growth, as even Germany has seen its economy stall. We think the pressure coming from a re-energized Japan with a now-cheap yen will force a change of thinking in export-dependent Germany. With a longstanding short euro position across our active asset allocation, we must admit that the wait for the euro to weaken toward €1.20 from €1.30 has been a long and frustrating one. But we continue to believe that a major depreciation of the currency will need to be part of the eurozone recovery story highlighted in Exhibit 7.

Exhibit 7: The Euro Holds Up, Euro Production Does Not



Submerging Markets

Europe's economy may be struggling, but its equity markets, both core and peripheral, have performed rather well over the past year. Emerging stock markets, by contrast, have been severe laggards, with the MSCI Emerging Market Total Return Index off almost 5% year to date and up only 6% in the last 12 months. For most of this period, country-by-country performances have varied widely. More recently, there has been greater correlation, to the downside. Exhibit 8 on the following page highlights these relationships.

Exhibit 8: Falling Like BRICS

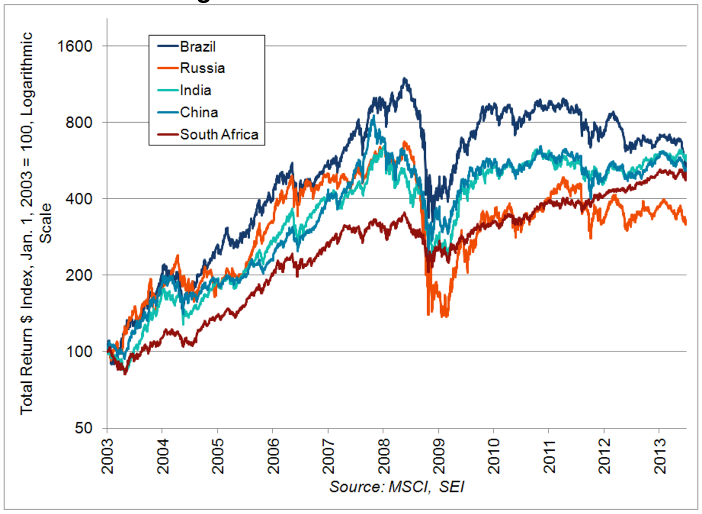
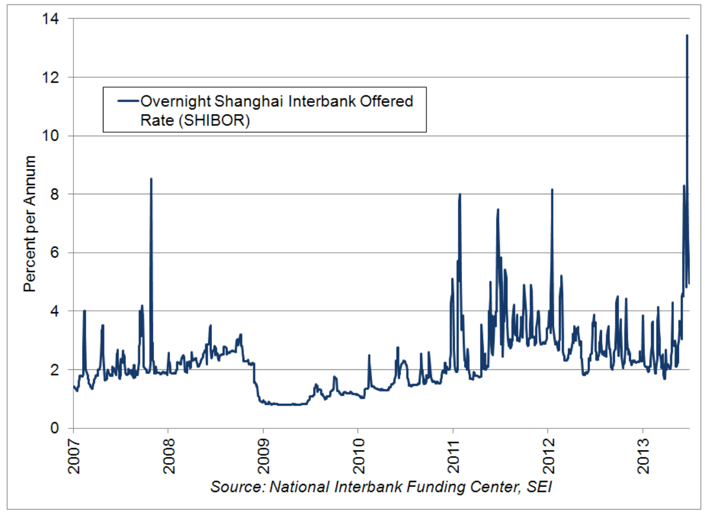


Exhibit 9: SHIBOR Rates



China has been particularly worrisome, given its economic importance to the rest of the world. Growth, while still robust versus that of most other countries, has been decelerating. Year-over-year GDP gains have slowed below 8%, and industrial output is advancing at less than a 10% pace. By comparison, in recent decades China regularly enjoyed GDP growth in the 10%-to-12% range, while industrial output hummed along at a 15%-to-18% pace during the 2003-07 expansion. Moreover, many observers doubt that recent gains are as strong as the official figures say.

The slowing of merchandise exports growth—with outright declines registered in the past year in exports to the U.S., Europe and Japan—is a well-known headwind. This has hurt other emerging economies, such as Taiwan, South Korea and Brazil that supply raw materials and semi-finished goods to China. The easing in Chinese demand has led to sharp price declines for many industrial commodities.

Unfortunately, China is not only challenged by a slowing of trade. There are long-festering domestic problems too. According to data from the Bank of International Settlements, private-sector debt as a percentage of GDP climbed to almost 170% as of September 2012, up from 118% at the end of 2008. Property speculation, corruption and rising wealth inequality have been big headaches for the country's economic leaders. The burgeoning of wealth management products and the shadow banking system has also complicated the government's management of the economy. The Bank of China's attempt to rein in this credit explosion appears to be creating a good bit of financial stress. The overnight Shanghai Interbank Offered Rate (SHIBOR) surged more than 11 percentage points between May 15 and June 20, as seen in Exhibit 9.

Brazil is another example of a big developing country that has run into economic difficulties. Its central bank had to increase its policy rate by 50 basis points in May following a 25 basis-point rise in April. The only other economically significant country to increase its policy rate this year is Indonesia (although other developing countries could hike their policy rates in the near future in order to prop up their skidding currencies). An accelerating inflation rate and a recent plunge in Brazil's currency have spurred this tightening of monetary policy. Unfortunately, the tightening comes at a time when economic activity remains well below the country's long-term growth potential. The Brazilian stock market has been hit hard this year, registering a price decline of more than 20%.

Although emerging market stock valuations are improving, there has been no real movement on the part of investors to increase equity exposure. Valuation metrics for emerging markets as a whole have improved only to their longer-term averages; they have yet to reach statistically cheap levels.

We think an economic turnaround in China would likely generate a good rally elsewhere in the emerging market universe. But China, in turn, needs an economically stronger developed world. A bottoming out of industrial commodity prices would be a key leading indicator of a return to health in Chinese demand. SEI's emerging market managers have mostly maintained positions in recent weeks, focusing on specific stocks rather than macro characteristics. There has been a slight allocation away from Latin America toward Asia, but we would not call it a big move. Like politics, investing in emerging markets is proving to be all local.

Active Positioning

We expect markets to stay on a choppy course in the months immediately ahead. The shift in Fed policy—away from asset purchases with no time limit to one where purchases will likely be tapered later in the year and ended in 2014—is a significant event. Outside the U.S., economic growth concerns abound in Europe, Japan, China, Brazil, India and other important countries. To complicate matters, the risk-on, risk-off calculus of recent years seems to be changing. Interest rates are rising sharply at the same time that stock markets are declining, and the traditionally less volatile industry groups are not providing the level of downside protection that would historically be expected.

Our most important active positions are shorts of the yen and euro against the U.S. dollar. These two trades look similar but reflect very different judgment calls. The short-yen position recognizes that the BOJ will do whatever it takes to lift the country out of its deflationary morass. Drastically increasing the central bank's balance sheet, depressing the yen in the process, is the primary focus of monetary policy. It does not pay to fight the BOJ. By contrast, entering a short euro position is definitely akin to fighting the ECB. The ECB's policies have continued to exert upward pressure on the euro. However, with depression-like conditions afflicting much of the currency area, recession threatening the core, and the euro's huge appreciation against the yen since November pressuring eurozone exporters (even Germany), we believe the political pressure for a weaker euro will intensify at some point. Granted, the euro's strength might not be easily reversed even if the ECB were to adopt a looser monetary policy. But in our view, it makes little sense for the ECB to doggedly pursue a policy course that keeps the euro at uncompetitive levels for all but the most efficient economies in the region.

As for equities, we have been looking for a garden-variety 5%-to-10% correction in the level of S&P 500 as a signal to overweight stocks versus bonds. In late June, the widely followed U.S.-equity benchmark moved into correction territory. European equities are down more sharply. Japan and some emerging markets, such as Brazil and Russia, have already endured statistical bear markets, with equity indices falling more than 20% from their highs of the year. The optimism that was so prevalent just a month or two ago is obviously dissolving. Surveys of investor sentiment suggested that money managers were heavily exposed to equities at the end of May. This is what happens when equity markets advance for eight consecutive months. The most recent weekly sentiment numbers have fallen into the upper end of neutral; more pessimism will likely take hold before the selloff fully runs its course.

In a similar vein, we would like to see the percentage of U.S. stocks trading below their 200-day moving average decline from the May highs of around 90% to 50% or less. At the end of June, this percentage was close to 80%. We do not expect extremely depressed readings of 30% or less unless economic fundamentals take an unexpectedly sharp turn for the worse. Prolonged bull markets need to take a breather once in a while, with most of the action occurring below the surface, as sectors fall in and out of favor. When it comes to most developed-country stock markets, there is no reason to expect a true bear market, in our opinion. Prices will need to get a lot more bubbly, and valuations much higher, before we get seriously concerned about the longer-term outlook for equities. We think this is a buy-on-the-dip opportunity—the only question is the timing.

Index Definitions

The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of 24 developed market country indices.

The **Barclays U.S. Aggregate Bond Index** is an unmanaged benchmark index composed of U.S. securities in Treasury, Government-Related, Corporate and Securitized sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $250 million.

The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization weighted index designed to measure the performance of global emerging market equities.

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There are risks involved with investing, including loss of principal. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Narrowly focused investments and smaller companies typically exhibit higher volatility. Bonds and bond funds will decrease in value as interest rates rise. High-yield bonds involve greater risks of default or downgrade and are more volatile than investment-grade securities, due to the speculative nature of their investments.

Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. TIPS can provide investors a hedge against inflation, as the inflation-adjustment feature helps preserve the purchasing power of the investment. Because of this inflation-adjustment feature, inflation-protected bonds typically have lower yields than conventional fixed rate bonds.

Diversification may not protect against market risk. There is no assurance the objectives discussed will be met. Past performance does not guarantee future results Index returns are for illustrative purposes only and do not represent actual portfolio performance. Index returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index.

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