Economic Outlook

Third Quarter 2012

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Central Banks to the Rescue

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- Central banks have taken significant steps to continue on a course of accommodative monetary policy, providing extra time for countries to make necessary reforms.
- Strong demand for yield has kept bond prices high and yields near all-time lows.
- Emerging markets appear attractive, while we expect the euro to slip versus the U.S. dollar and commodities to rise as uncertainties around U.S. politics and the European debt crisis continue to rule.

Talk about climbing a wall of worry! Risky assets surged during the third quarter, building upon a rally that started in early June. Some of the strongest-performing markets – European financial stocks, Spanish and Italian bonds, gold and commodity equities, to mention a few – had been among the worst performers for the better part of this year and last. In previous quarterly commentaries, we recognized that trading had become rather one-sided. The scramble into safe-haven investments has pushed U.S., German and British government bonds to record-low yields and created tremendous performance disparities. However, we have been surprised by the speed and extent of the rally, as the debt crisis in Europe and the fiscal problems in the U.S. are far from resolved.

So Far, So Good

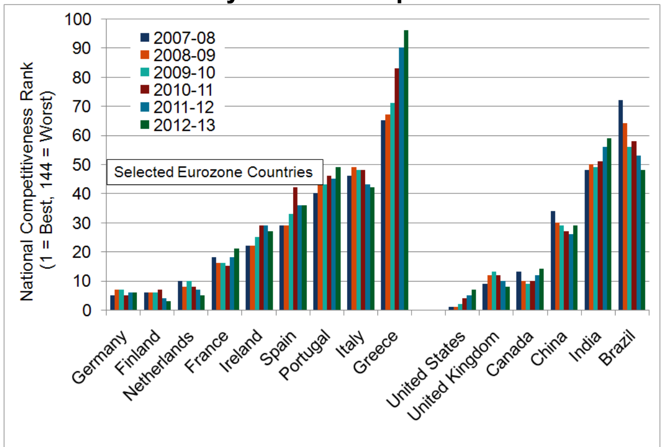
Much has gone right in Europe over the past few months. In mid-June, the Greek elections brought the conservative New Democracy party back into power, resulting in a coalition with the Panhellenic Socialist Movement party. Although these are the same actors that helped cause the economic mess in Greece in the first place, they at least have shown a willingness to negotiate with the European Commission, the European Central Bank (ECB) and the International Monetary Fund (aka, "the Troika") in order to qualify for additional bail-out funds and remain in the eurozone.

Nonetheless, we remain highly skeptical that the Greek saga is coming to a successful conclusion. The elections certainly brought relief – the Greek stock market has climbed almost 40% since mid-June. Yet, the country's basic problems remain. It cannot service its debt under any realistic scenario without debt forgiveness and fiscal transfers. Nor can it easily increase its competitiveness within the confines of the currency union.

The World Economic Forum (WEF) recently released its latest findings on country competitiveness. These global rankings are based on the WEF's 12 "pillars of competitiveness", [1] providing a comprehensive picture of the competitive landscape in countries around the world at all stages of development.

Exhibit 1 highlights a selection of countries and how their rankings have evolved since the 2007-08 report. A few things stand out. First, the most competitive countries in the eurozone (Germany, Finland and the Netherlands) have maintained or improved their positions since the 2007-08 global economic high point. Meanwhile, the rankings of Europe's periphery countries (with the exception of Italy) have declined.

Exhibit 1. Austerity Doesn't Help



Source: World Economic Forum, SEI
Rankings for 2012-13 include 144 countries

The Greek experience is sobering. Despite the bail-outs, the private-sector initiative that reduced its debt burden,

[1] "The Global Competitiveness Report 2012-2013," World Economic Forum, Davos, Switzerland, 2012, p. 13. The 12 pillars include Institutions, Infrastructure, Macroeconomic Environment, Health and Primary Education, Higher Education and Training, Goods Market Efficiency, Labor Market Efficiency, Financial Market Development, Technological Readiness, Market Size, Business Sophistication and Innovation.

ECB purchases of its bonds via the Securities Market Program, and the panoply of austerity measures aimed at reducing wages to more competitive levels, Greece has seen a massive deterioration in its rankings. The country ranked 65 in the world five years ago. Now it ranks 96, just behind Serbia and just ahead of Jamaica.

According to the WEF's methodology, Greece now ranks dead last in macroeconomic environment, and scores very poorly in labor and goods market efficiency, financial market development and basic institutions.

One might argue that exiting the eurozone and sharply devaluing its currency would not do much good for a country whose biggest impediments are inefficient government bureaucracy, access to financing, and policy instability. But, then, what good has it been to stay in the eurozone? Unemployment is at 25%. GDP has declined at least 20% since 2007. And the country is still in no position to honor its debts.

In our opinion, the odds still favor a Greek exit. We therefore expect contagion fears to make an eventual comeback. Portugal, slightly smaller than Greece in terms of population and GDP, could be the canary in the coal mine. Its debt load is not quite as onerous. But it has lost competitive ground in recent years, falling nine places in the WEF rankings since 2007. Interestingly, Portuguese 10-year benchmark bond yields have collapsed, falling to 8% from 16% in January. Bond yields are now slightly below the level of 2-1/2 years ago, when Portugal was bailed out. We believe Portugal's bond market will be especially vulnerable in the event of more periphery turmoil.

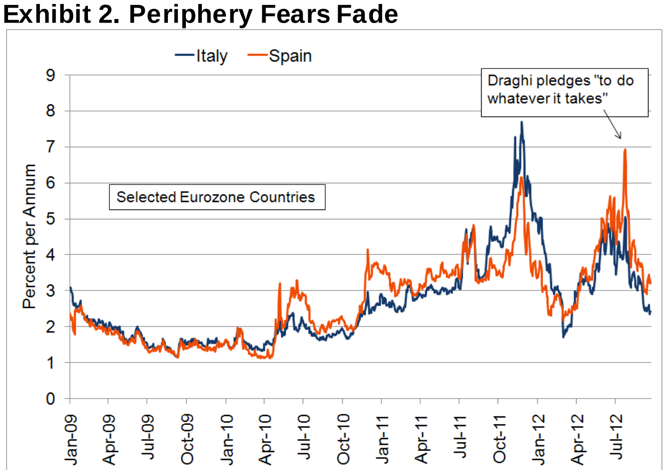
OMG! It's OMT!

The Greek election may have been the first piece of good news that helped ease the European debt crisis. But it was not the biggest reason for the rebound in European equity markets or the euro. That honor must go to ECB President Mario Draghi, who pledged in July to do "whatever it takes" to keep the euro intact. Mr. Draghi made good on that pledge in early-September with the introduction of the Outright Monetary Transactions (OMT) program. Under this program, the ECB will be able to purchase unlimited quantities of periphery sovereign debt in the secondary market. This program represents a big step forward in establishing the ECB as the eurozone's lender of last resort.

The details of the program are worth reviewing. First, the ECB will buy the sovereign debt of troubled borrowers only when the country in question agrees to strict economic reform conditions that would be attached to any bail-out from the European Financial Stability Facility (EFSF) and the EFSF's successor, the European Stability Mechanism (ESM). Significantly, the OMTs will not have seniority creditor status, in contrast to the EFSF /ESM or the ECB's previous bond-buying program (the Securities Market Program). This will ease the risk of private-creditor flight in the face of central-bank intervention.

Debt purchases will be limited to government securities in the one-to-three year maturity range. This meets one of the demands of the Germans, who viewed purchases of longer-term debt as an illegal monetization of deficits. Frankly, we find this to be a distinction without a difference. Government debt is still being purchased by the monetary authority. Be that as it may, the response by markets was electric. As shown in Exhibit 2, Spanish and Italian two-year note yields have collapsed since July 20, when Mr. Draghi made his "whatever-it-takes" remarks. Investors realized that the central bank will be able to manipulate interest rates in various countries, helping to reduce financing costs for debtor governments and lowering the sovereign default risk facing bondholders.

Exhibit 2. Periphery Fears Fade



Source: Thomson Reuters/Datastream, SEI

There is, however, an unintended consequence resulting from the ECB's successful effort to reduce the risk premiums in periphery bond yields, namely, the introduction of moral hazard. As we said above, the OMT program comes into effect only after a borrowing country agrees to the conditions that would permit an EFSF/ESM bail-out. The interest-rate declines of the past two months, however, have eased the pressure on Spain and Italy to take this bitter medicine. Spanish Prime Minister Mariano Rajoy is now delaying a decision to seek a bail-out, unwilling to agree to additional conditions or oversight. Italian Prime Minister Mario Monti also has rejected additional conditions in return for aid. It is possible that more turmoil in the sovereign debt markets of Spain and Italy will be required before those governments come to terms. The alternative scenario would be for the bail-out terms to reflect the austerity measures already in place – a result that could upset the Germans and other creditors who are less than enamored with the idea of keeping the periphery afloat.

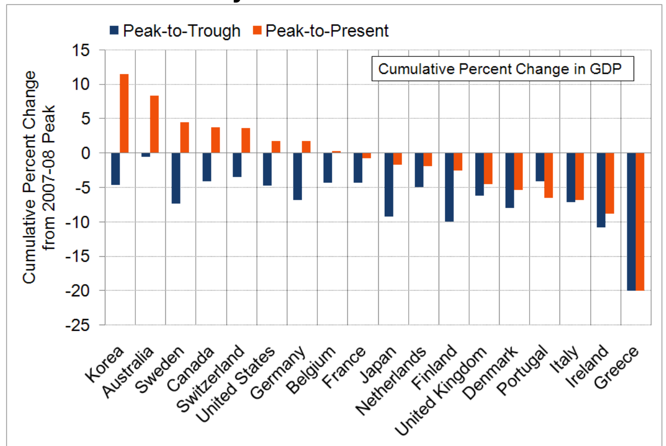
In similar fashion, the ECB president has vowed that once a country is a participant in the OMT program, it will be closely monitored. If it were to wander off track (not pushing through promised reforms, for example), OMT support would be withdrawn. We wonder if this is a credible threat. Presumably, a country would be at greatest risk of backtracking at a time when austerity measures are pushing the economy into deeper recession. Would the ECB really turn off the liquidity spigot at precisely the time it is most needed?

One last detail of the OMT should be mentioned. Although there is no limit on OMT purchases, they will be sterilized. This means that the ECB will remove the excess liquidity that would otherwise have been created; the OMT program will not expand the ECB's balance sheet. This is analogous to the Federal Reserve's Operation Twist program that has been in effect over the past year. The purchase of Treasury bonds at the longer end of the yield curve has been offset by sales of shorter-dated Treasury securities. In the case of Operation Twist, this has resulted in a flattening of the yield curve, no growth in the Fed's balance and only a modest 6%-7% increase in the M2[2] money supply.

We realize that the promise to sterilize OMT purchases is another concession made to the Germans to gain the support of Angela Merkel's government. But sterilizing the OMT bond issuance will do nothing to alleviate the painful recessions currently underway in the periphery countries. Nor is it likely to prevent core-country economies from slipping further toward recession.

Exhibit 3 compares the performance of a variety of developed economies. For each country we measure the change in inflation-adjusted GDP from the peak of the previous cycle in 2007-08 to the trough in 2009 (or later, depending on the country), and also from the previous peak to the middle of this year. For the most part, the countries highlighted experienced peak-to-trough declines from almost 5% to 10%. However, the recoveries since 2009 have been especially meager among the countries of Europe. The periphery economies of Europe remain more than 5% below their 2007-08 highs. Greece once again is in a class by itself, registering an almost unremitting decline that has seen the economy sink by 20%.

Exhibit 3. Recovery Scorecard



Source: National Sources, SEI

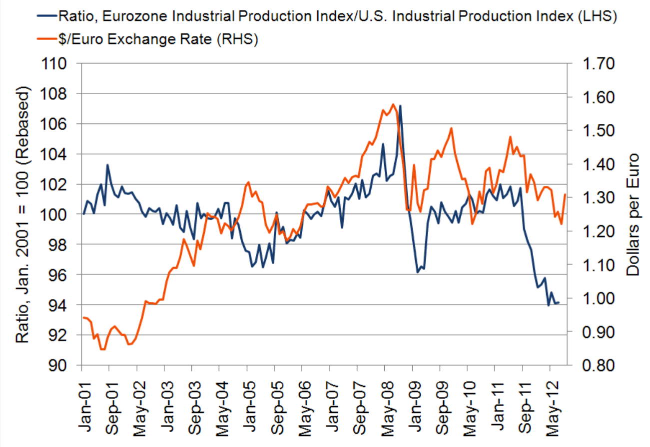
Sterilized bond purchases could have the perverse result of propping up the euro. As it is, the euro has already advanced some 8% off its early-June low. At a recent peak of $1.32 per euro, we believe the eurozone currency is damagingly high for the uncompetitive periphery countries. If a country's private sector is in the throes of deleveraging, it cannot count on consumption or investment to pull the economy out of recession. If government spending is also being throttled back, where will demand come from? The only answer is the external trade sector – exports must carry the day. A rising currency undermines this avenue to growth. We therefore have little expectation that the eurozone will be able to pull itself out of its economic morass anytime soon.

We continue to believe that a depreciation of the euro must be one component of an integrated strategy to improve the eurozone's growth prospects. Debt forgiveness and/or debt mutualization, wealth transfers from rich countries to poor, and fiscal integration and banking union will also be parts of any permanent solution to the crisis. We are still far from that point.

Exhibit 4 compares the euro's exchange rate versus the dollar against the relative performance of industrial production in the eurozone and the U.S. Since 2003, there has been a tendency for the euro to weaken when the eurozone's industrial production index lags that of the United States. Although causation can be debated, we think it's the currency that responds to changes in the economic fundamentals. And so, it's our bet that the euro continues to be dragged lower as the eurozone's production declines relative to that of the U.S.

[2] The M2 measure of the money supply includes cash in circulation, travelers' checks of non-bank issuers, checking accounts, savings accounts, smaller CDs, non-institutional money market accounts and overnight repos at commercial banks.

Exhibit 4. The Euro Slides with Economic Performance



Source: Euro Stat, Federal Reserve Board, Thompson/Reuters, SEI

The U.S.: QE to Infinity and Beyond

Let's call it a case of monetary one-upsmanship. Only one week after the European Central Bank unveiled its OMT program, the U.S. Federal Reserve (Fed) announced its third quantitative easing initiative in the past four years. In some ways, the Fed's approach could prove even more expansive than that of the ECB. The Fed has pledged to purchase $40 billion of mortgage-backed securities (MBS) each month for as long as it takes to bring the unemployment rate down to a level it believes to be more consistent with its dual mandate of maximum employment and price stability. This is on top of the current program of reinvesting interest and principal payments generated by its current portfolio of agency debt and MBS. In total, some $60 billion of agency MBS will be purchased each month, an amount that is more than double the current average monthly issuance of agency MBS. Finally, the Fed will continue to lengthen the maturity of its Treasury portfolio until Operation Twist expires at the end of December.

In contrast to the ECB's new program (or the Fed's on-going Operation Twist program), there will be no attempt to sterilize the agency MBS purchases. The Fed's balance sheet will be allowed to expand without time or magnitude limits (hence, the "infinity" reference for which will use "QE∞" as a nickname). The Federal Open Market Committee (FOMC) made it crystal-clear that it will do whatever it takes to push the economy onto a higher-growth track. In its September 13 press release, the FOMC policymakers said, "If the outlook for the labor market does not improve substantially, the Committee will continue its purchase of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability."

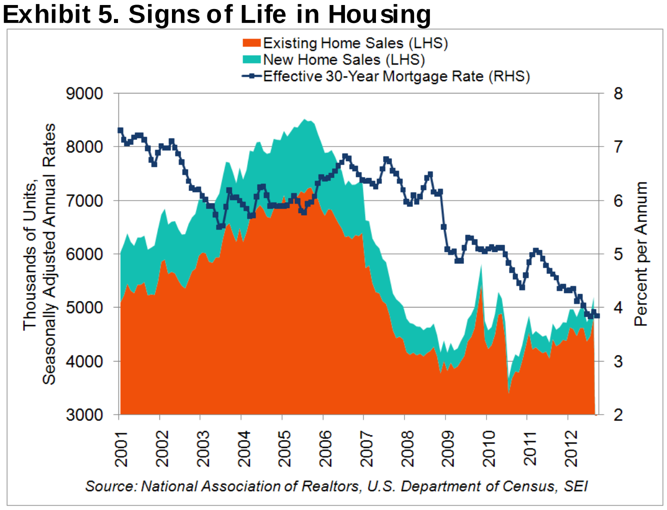
We think this sentence implies that the Fed may continue its purchases of longer-dated Treasurys after Operation Twist ends, without the need to sterilize those purchases by selling shorter-term securities. The press release went on to say that "…a highly accommodative stance will remain appropriate for a considerable time after the economic recovery strengthens." The prevailing view among Fed Governors and regional Presidents is now for the federal funds rate to stay near the zero boundary through mid-2015. ECB President Mario Draghi is probably suffering from a bad case of bazooka-envy.

How effective will QE∞ be in terms of boosting economic growth? We have our doubts. It surely made sense to forestall the monetary cliff (i.e., the expiration of Operation Twist) that occurs at year-end along with the fiscal cliff. That noted, the addition of more liquidity and the maintenance of record-low interest rates are not the game-changers that they were at the height of the debt crisis in 2008-09. Although Fed Chairman Bernanke argued otherwise in his Jackson Hole speech at the end of August, we do not think that economic growth was boosted in any dramatic fashion by the second round of QE between November 2010 and June 2011. It did have a positive impact on equity and commodity prices and a negative impact on the value of the dollar, however.

The Fed hopes to accelerate the housing recovery through the purchase of agency MBS. Yet, mortgage rates are already so low that the impact on a typical mortgagee's monthly cash flow should be rather small. A real-life example is instructive. In mid-September the effective mortgage rate on a 30-year fixed-rate loan was 3.85%. The monthly mortgage payment on a $300,000 loan works out to be $1,400 at that interest rate. If rates were to fall one percentage point as the result of QE∞, the monthly payment would drop to $1,240. Multiplied over the course of the year, the savings of almost $2,000 would be equivalent to the payroll tax break on Social Security that has been in place over the past two years. No one views the payroll tax break as a macro-economic game-changer (although no one will be happy if the payroll tax break expires at year-end as part of the fiscal cliff). Additionally, a lower mortgage rate will do nothing for those who have poor credit scores or are underwater on their existing mortgages. Those homeowners will continue to labor under much higher mortgage payments regardless where current rates go.

On the positive side, the Fed is pushing on an open door. The central bank is engaging in another round of QE at a time when the economy and financial system are nowhere near as weak as they were (or, at least, appeared to be) in 2008 or 2010. There are fewer concerns about the U.S. falling into a double-dip recession -- unless one assumes that the politicians in Washington cannot agree to delay or modify the coming fiscal contraction. Housing, in particular, has started to show more signs of life in sales and prices (see Exhibit 5). Also, the stock market itself is considerably stronger than when the previous two QE efforts or Operation Twist were put into effect. In the same vein, the onset of QE1, QE2 and Operation Twist coincided with low and declining inflation expectations. Inflation expectations at present are relatively high and climbing.

Exhibit 5. Signs of Life in Housing

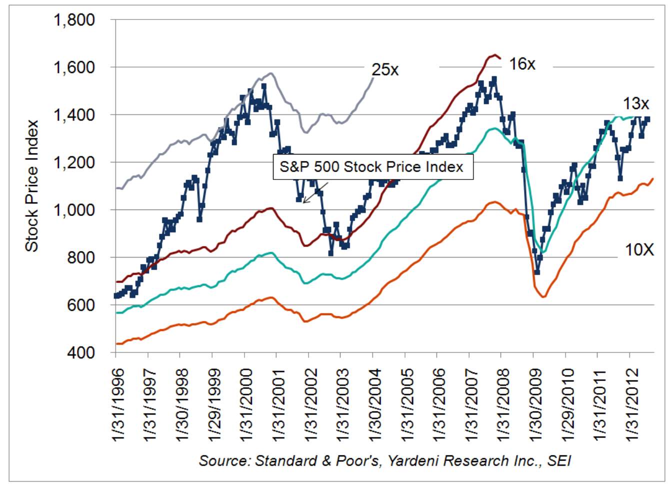


We believe the primary impact of QE∞ will be felt in the financial markets, not the economy itself. The Fed's determination to keep interest rates at very low levels will continue to force investors into riskier assets. Money will likely continue to flow into investment-grade corporates, high-yield bonds, emerging-market debt and into equities. That said, the fixed-income assets are starting to look expensive. Yields across the risk spectrum are plumbing new lows. Granted, spreads versus Treasury bonds remain relatively attractive. But, with Treasury yields near all-time historical lows, we find it hard to get excited about the prospects for capital gains in most areas of the fixed-income market.

U.S. equities provide an analogous conundrum for investors searching for adequate total returns. Following a modest two-month correction in April and May, the S&P 500 has rallied smartly, thanks to developments in Europe and the Fed's expansionary monetary policy. This rally in U.S. equities has come at a time when corporate profitability has been under some downward pressure.

Exhibit 6 plots the S&P 500 stock price versus different price/earnings ratios over time. Since the P/E lines are focused on a specific multiple (10 times, 13 times, etc.), they fluctuate with the changes in one-year forward earnings estimates. Currently the S&P 500 is trading at a forward-earnings multiple of 13. Since the 2008 financial crisis, a price-earnings ratio of 13 has represented something of a valuation barrier for the S&P. Stock prices rose to above that valuation level coming out of the economic downturn, but the sharp recovery in corporate profits justified investors' bullishness. As the upward trajectory in earnings slowed in 2010-11, however, the 13x earnings area has become a more formidable hurdle.

Exhibit 6. Stock Prices versus Valuation



It is important to point out that this is not a steep multiple when taken in historical context. During the 1999-2000 tech bubble, stocks reached 25 times on an elevated estimate of forward earnings. The ensuing bear market (a 45% price decline) represented the combination of a 10% decline in profits and a contraction of 10 percentage points in the multiple applied to those earnings. In other words, the contraction in the multiple accounted for about three-quarters of the entire decline in stock prices.

In absolute-price terms, the S&P is again closing in on its March 2000 high – with an earnings level that is almost twice as high as it was 12-1/2 years ago and an earnings multiple that is only half the 2000 peak multiple. Current valuations are simply not consistent with a major bull-market top.

In our opinion, the economy will continue to grow at a sluggish pace despite the extraordinary actions taken by the Federal Reserve. Although QE∞ may prove incrementally helpful, it does not address the underlying issues that have restrained the growth in business activity. The credit boom preceding the 2007-08 meltdown was bigger and included more developed countries than any debt bubble in history. It's not surprising, then, that the ensuing bust resulted in a sharper and more widespread economic downturn than anything seen since the 1930s.

The U.S. is further along the path of deleveraging and financial system repair than the countries of Europe, but it has yet to address the liability problem (both actual and contingent) lodged on public balance sheets at the federal and state levels. Economic headwinds will continue to blow as government retrenches, taxes rise and regulatory reform depresses the "animal spirits" needed for a robust economy and financial market.

We would argue that political uncertainty has contributed to the sluggish tone of economic activity. Whose taxes are going up and by how much? Will the fiscal cliff actually occur? What other regulations affecting industry and finance will be coming down the pike? How will the Affordable Healthcare Act and Medicare reform affect my healthcare choices? No wonder consumer and business sentiment remains rather depressed more than three years after the official end of the recession, despite record-low interest rates and record-high debt purchases by the Fed.

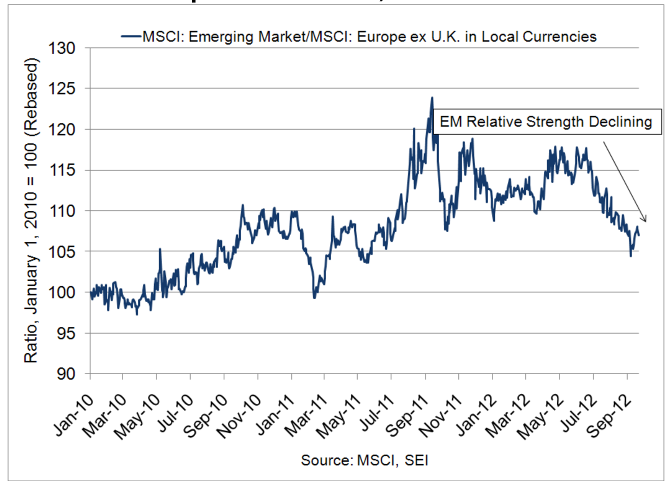
It's been our view that the extraordinary monetary and fiscal actions taken by the federal government in the teeth of the crisis were necessary and proper. Unusual and controversial steps had to be taken to prevent a wholesale collapse of the financial system and a full-blown economic depression. One can always point to specific decisions that may seem, perhaps were, ill-considered. But the need to act quickly and decisively was paramount.

Unfortunately, the government's fiscal and monetary actions back in 2008-09 continue to exert an economic impact today, eliciting yet more and potentially destabilizing actions, such as QE∞. Although the message gets muddled in the heat of a Presidential campaign, the crisis and its aftermath have changed the terms of the national debate on the proper role of government in the lives of its citizens. Regulatory reform of the financial system, a more direct and activist government role in industrial policy (including finance, industry, healthcare and energy) and higher taxation on income and capital gains are changes that have already occurred or will likely be put in place in the years ahead. The imperative of regaining control over the government's finances through entitlement and tax reform should be a priority for the next Administration.

An Emerging Play in Emerging Markets?

Since the risk-on rally started in June, emerging market equities have been notable by their lack of participation. Aggressive investors have used European equities as their vehicle of choice. We remain skeptics on European equities, given the economic and financial headwinds. Consequently, we view the recent weakness in EM equity versus Europe as an opportunity (see Exhibit 7).

Exhibit 7. Europe Goes Boom, EM Goes Blah



As previously mentioned, a permanent resolution to the European debt crisis is still far way, even if one believes that recent developments represent progress. Emerging markets also enjoy structural advantages, including more dynamic economies, lower debt burdens, rapidly expanding trade with each other and a burgeoning middle class. Although we currently have no active (short-term) tilt away from our strategic (long-term) allocation to European equities in favor of emerging markets, our inclination is to look for a timely opportunity to enter such a trade.

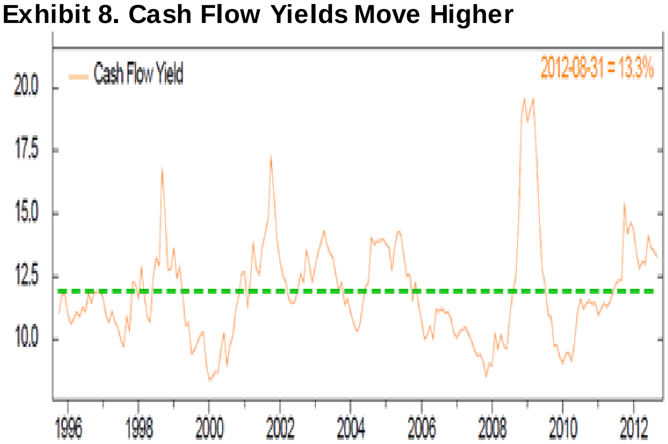
We are thinking that emerging markets will be a 2013 story. It's partially a matter of gaining enough confidence that the slowdown in China is coming to an end. The preponderance of data does not indicate that this is yet the case. Industrial production growth had eased to its lowest rate since 2009; at a year-over-year pace of 9%, it is well below the 15%-plus gains recorded in most years since 2003. Europe's recession has cut Chinese merchandise to the region by more than 10% in the past year. Since we expect Europe's downturn to be prolonged, China's export machine will continued to be challenged, as will other export-oriented developing economies.

Finally, China – the lynchpin of the emerging-markets equity story for the past decade – continues to face structural challenges as it tries to increase domestic consumption and reduce its dependence on exports, property speculation and investment in infrastructure and heavy industry. In this regard, a recently announced stimulus package reflected Chinese leadership's inability to get beyond its comfort zone – the package highlighted old-fashioned pump-priming, with the emphasis on the construction of railways, roads, harbors and airports.

Despite these fundamental economic concerns, emerging-market (EM) investors have reason to be optimistic. First, much like their developed-country counterparts, EM central banks have been pursuing more expansionary monetary policies. In contrast to 2010-11, when inflation was the focus of concern, a return to growth has become the priority. Exchange rates have weakened for a number of countries, and strong investor demand for higher-yielding securities has pressured bond yields lower.

The poor relative performance of emerging markets over the past two years also has improved valuations. While one can argue the pessimistic case that EM stocks are cheap for a reason, it is a fact that valuations have improved. Cash-flow yields have climbed from almost 9% in 2010 to 14% as of mid-year, as shown in Exhibit 8. Although the current reading remains below the spikes recorded in 1998 (the Asian Contagion and Russia's default), 2001 (global recession, 9/11) or 2008-09 (deep recession, global debt crisis), we judge it to be attractive at a time when the majority of central banks in both developed and developing nations are intent on re-inflating their economies.

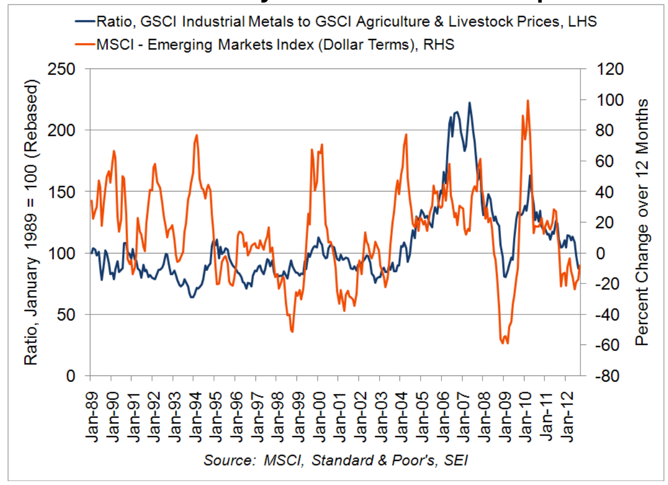
Exhibit 8. Cash Flow Yields Move Higher



Source: Ned Davis Research, MSCI

We are watching commodity prices closely to determine the path of emerging economies. Exhibit 9 tracks the ratio of industrial metals prices versus agricultural and livestock prices. This ratio has plunged over the past two years, coinciding with very poor EM equity performance. The rationale: Food prices are a large part of household budgets in developing economies. When food prices rise sharply, disposable incomes get squeezed and EM central banks are compelled to raise interest rates and tighten monetary policy in an effort to diffuse a growing inflation problem. By contrast, when metals prices are rising at a faster rate than food (the ratio is rising), it's a sign that economic growth is accelerating.

Exhibit 9. Commodity Prices versus EM Equities



The introduction of QE∞ has sparked a rally in industrial commodity prices. Previous QE episodes also were accompanied by a commodity-price revival. This should be good news for EM countries that export raw and semi-finished goods. If EM currencies rebound as a by-product of the Fed's latest policy move, the outlook for EM equity should change for the better.

So Much Activity, So Little Certainty

As the fourth quarter begins, we now know the answer to some questions we didn't know three months ago. For example, we now know central banks in most parts of the world have redoubled their expansionary efforts in an attempt to re-inflate their economies. The Fed, the ECB, the Bank of England and the Bank of Japan are all engaging in extraordinary quantitative easing operations in one form or another. The Fed and the ECB, in particular, are pursuing "whatever it takes" policies. The Fed has made it quite clear that it will stick with an aggressive monetary policy until the unemployment rate comes down dramatically; the ECB will do whatever it takes to keep the eurozone from unraveling. We also know that the Merkel government in Germany has carefully shifted its support in favor of Mr. Draghi's actions, giving the periphery more time to work through its problems.

Some big uncertainties remain, however. There is no guarantee that QE will work in any of these countries. QE policies may buy time, which is a good thing, but they do not get at the heart of the problem. For example, long-term promises have been made by developed-world governments to their aging populations in the form of medical, pension and other income support programs that cannot be sustained in their current forms.

Various European countries have already hit the fiscal wall and are now in the midst of painful restructuring efforts that are leading to deeper-than-expected recessions. In the U.S., entitlements have not yet been addressed at the federal level, but disruptive changes are taking place at the state and local levels that are hindering economic growth. QE cannot resolve these problems.

Our Funds

From an investment positioning standpoint, we have adhered to a neutral stock-bond view in terms of asset allocation, maintaining parity between our strategic (long-term) allocations and our active (short-term) allocations. We have been thinking that equities were extended in a short-term sense, and that some consolidation was likely. That pullback obviously has not occurred, thanks to the forceful actions taken by the Fed and the ECB. There are, however, some make-or-break events that could still cause turmoil in financial markets. The Greek government, for example, needs to get another tranche of bail-out money in October, or it will likely default on its debt obligations. In the U.S., politicians need to deal with the fiscal cliff that kicks in on January 1, with the price of failure a possible U.S. recession. Meanwhile, China's economy continues to show signs of wear and tear, hurt by the slowdown in trade with Europe and a diminishing cost advantage versus other emerging-market competitors.

While it may be hard to judge how markets will move in the months immediately ahead, we do have more confidence in some longer-term themes. An investment strategy that emphasizes equity and other risk assets over safe-haven bonds seems justified in view of record-low yields and the determination of central banks to keep interest rates at extremely low levels for the next few years. This same rationale would favor investment-grade credit and high-yield bonds over Treasurys within the fixed-income space. Within equities, our longer-term inclination is to go where the relative growth is. That implies an emphasis on the U.S. and emerging markets over developed Europe.

Finally, we continue to expect a meaningful depreciation of the euro towards parity with the dollar. A short euro position continues to be the primary investment bet in our active asset allocation efforts at this time. We acknowledge the fact that the Fed's previous QE efforts have caused the dollar to weaken. But we think this time might be different because (1) the euro has already strengthened significantly since early June; (2) the eurozone economy remains the weak link globally; (3) the fiscal and banking crises within various European countries are far from resolved, even if some progress has been made ; (4) a weaker currency is essential for growth in the European periphery; and (5) the U.S. Fed is not engaging in QE unilaterally – almost all the major central banks are pursuing similar policies.

As year-end approaches, we hope the outlook will clarify sufficiently to begin aligning our active positioning with these longer-term themes.

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To determine if the Funds are an appropriate investment for you, carefully consider the investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Funds' prospectuses, which can be obtained by calling 1-800-DIAL-SEI. Read them carefully before investing.

There are risks involved with investing, including loss of principal. Current and future portfolio holdings are subject to risks as well. 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.

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.

Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

- ***Not FDIC Insured***
- ***No Bank Guarantee***
- ***May Lose Value***