Economic Outlook

Third Quarter 2013

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The Fed Goes Taperless

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- The Fed's stimulus efforts will continue, but partisan politics in Washington are creating uncertainty.
- Europe's economy is still struggling, while emerging markets look more attractive.
- While volatility is likely and a pullback is possible, we continue to expect equity markets to muddle along.

"October: This is one of the peculiarly dangerous months to speculate in stocks in. The others are July, January, September, April, November, May, March, June, December, August, and February."

Mark Twain, *Pudd'nhead Wilson's Calendar for 1894*

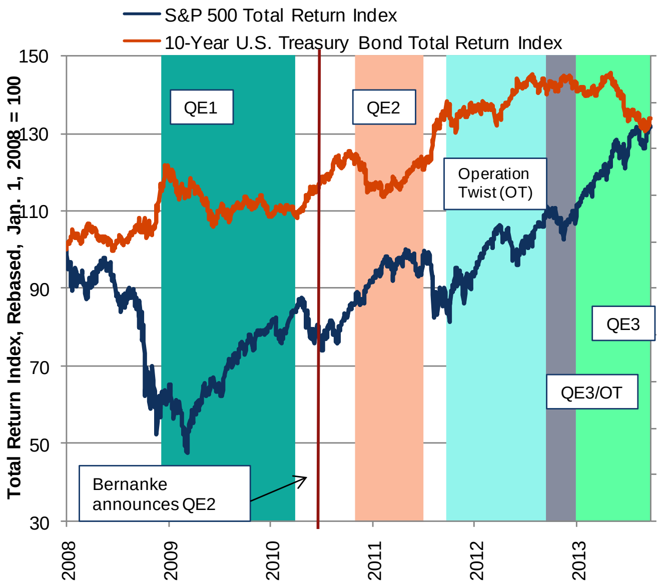
We wonder if Twain's Pudd'nhead Wilson would be as skeptical of stocks today. So far this year, developed-world equity markets have risen more than 19%, hitting only a few potholes along the way. The most serious setback occurred in the May-to-June period, when Federal Reserve (Fed) Chairman Ben Bernanke broached the possibility of tapering the central bank's bond purchases later in the year. Even before the unexpected announcement that quantitative easing (QE) in the U.S. would be maintained at its current pace, stocks had been enjoying a nice bounce from their August lows. Indeed, U.S. equities (up more than 20% in total-return terms this year) have now managed to advance for more than 500 trading days without a 10% peak-to-trough correction, according to Ned Davis Research. By comparison, the average duration between 10% corrections in the S&P 500 price index amounts to 161 trading days since 1928. It's also been 1,150 days since we've seen a 20% correction (although we came close in the summer of 2011) versus an average hiatus of 635 days. This multi-year bull market is now slightly longer than the average secular bull.

Bull markets, however, do not usually die of old age. They get murdered—and the killer is often monetary policy, using interest rates and tight monetary policy as the weapons of choice. We have been steadfast in our constructive view of equities, particularly in the U.S., for the simple reason that the Fed made clear its intention to keep interest rates at ultra-low levels and to employ QE efforts until the economy responds as desired.

On September 18, the Fed reiterated this stance in dramatic fashion. Not only has the tapering of its bond-buying program been delayed, but it appears that its zero-interest rate program will be extended further into 2015, with the majority of Federal Open Market Committee members expecting the Fed funds rate to be at or below 2% through 2016. When Bernanke announced the latest installment of QE in September 2012, we half jokingly referred to it as "QE ∞" to highlight the open-ended (infinite) nature of the program. With the apparent jettisoning of a specific, albeit unofficial, threshold at which the Fed expects to cease its bond purchases, QE looks like it's here to stay for quite a while.

So what does this mean for investors? Exhibit 1 on the following page depicts the various bond-buying programs pursued by the Fed since the financial crisis in 2008. The two lines in the chart simply track the cumulative total returns of the S&P 500 Index and the 10-year Treasury bond. We think the chart suggests that QE is clearly good for the equity market; the impact on bonds is less positive and very inconsistent. Of course, at any point there are a plethora of macro and micro factors that influence stock and bond prices. We're not pretending to ascribe all the impact on stocks and bonds to QE, but the results are suggestive and investors have been conditioned to associate QE with increased liquidity and stock-market-friendly economic conditions. Note, in particular, the reaction of stock prices when Bernanke simply announced the second round of QE (QE2) at the August 2010 Jackson Hole conference. Even Operation Twist, which did not increase the Fed's balance sheet and merely changed its composition to include a larger share of long-term Treasurys, seemed to spark a durable rally in U.S. equities.

Exhibit 1: That Peaceful, Q-Easy Feeling



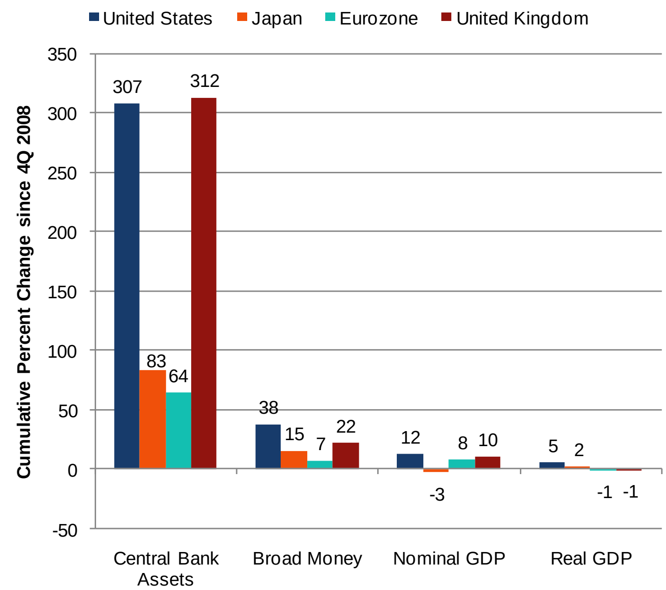
Source: Barclays, Federal Reserve Board, S&P, Ed Yardeni Research, SEI

Oddly, the Fed has been less successful in guiding the bond market in the desired direction. Treasury bond prices fell and yields rose during QE1, QE2 and, thus far, during QE3. Operation Twist was more successful in pushing prices higher and yields lower, but the best performances recorded by the bond market since 2008 have coincided with the times quantitative easing was not in effect. We think this reflects the risk-on, risk-off calculus of investors in the post-crisis period. When the Fed tries to wean the markets from QE, worries about the recovery's sustainability come back to the fore. Investors return to safe-haven assets as a result.

Most would argue—including Bernanke—that the impact of QE on the real economy has been disappointing. In our view, the implementation of QE1 in December 2008 (during the apex of the financial crisis) was the correct call. It served to stabilize the markets and calm the panic, setting the stage for economic recovery seven months later. In our judgment, though, QE has been far less effective in its primary goal of boosting economic growth and employment. Supporters of the approach are only left with the counterfactual argument that current economic conditions would be worse without it.

Exhibit 2 provides an international perspective of QE. It shows the cumulative percentage change in the assets of the Fed, the Bank of Japan (BOJ), the European Central Bank (ECB) and the Bank of England (BOE) since the fourth quarter of 2008. It compares those gains to the cumulative changes in the money supply and economic growth, both nominal and real, in all four regions. The Fed and the BOE have each seen a quadrupling in size of their balance sheets. Both central banks were exceptionally aggressive in their provision of bank reserves during the crisis five years ago. While the U.S. was engaged in Operation Twist, which did little to grow the Fed's balance sheet, the BOE under former Governor Mervyn King was engaged in an aggressive round of bond buying between October 2011 and November 2011. The BOE's assets doubled over this span. Since the end of last year, however, the BOE's balance sheet has contracted slightly, while the Fed's assets have expanded sharply under the QE ∞ regime.

Exhibit 2: QE Springs a Leak



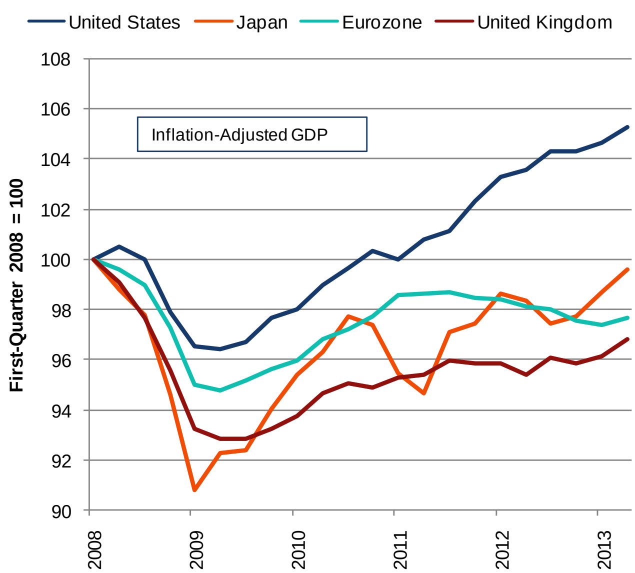
Source: FactSet, SEI

By coincidence, the two QE laggards—the ECB and BOJ—have recorded similar expansions in their assets since 2008. The BOJ, however, did not start to see an expansion in its balance sheet until late 2010. It has only been since April that the Japanese central bank began a Bernanke-style QE regime in earnest. The BOJ is on pace to double its assets inside of 12 months. One reason Japan was so slow to join the QE party was its prior lack of success in jump starting economic activity after increasing its assets by about 75% between 2000 and 2002. Bernanke actually gave a speech in Japan in 2003 urging the BOJ to become even more aggressive in its battle against deflation. While the Japanese did not listen at the time, they seem to be full converts now.

Today, it's the ECB that is playing the role of the QE non-believer amid sluggish economic conditions and deflationary pressures. ECB President Mario Draghi and his colleagues have allowed the central bank's assets to contract in an unprecedented fashion—nearly 25% in a year's time. Bernanke must be scared out of his wits, drawing parallels in his mind not only with Japan in 2003 but also with the Fed's own experience during the early years of the Great Depression. Exhibit 2 suggests, however, that the pipeline from a central bank's balance sheet through the banking system and then on to the real economy is a very leaky one. It takes a lot of bond buying to boost money and credit, and even more to boost the economy in this post-crisis world. By the same token, a contraction in a central bank's balance sheet has a much smaller impact than one would expect. Just look at the eurozone versus the U.K. Over the past five years, the ECB's asset growth has been only one-fifth that of the BOE. The cumulative change in real gross domestic product (GDP) over the past five years, by contrast, is virtually the same.

It is true that the U.K. has enjoyed better economic performance than the eurozone more recently. Meanwhile, the two countries with currently active QE programs—Japan and the U.S.—have done better still, as seen in Exhibit 3. Our verdict on QE: It has a positive effect, but it isn't the panacea that Bernanke and other central bankers hoped it would be. It surely helps boost interest-rate sensitive sectors of the economy, notably housing and autos. And it has been very positive for the stock market and home prices. This has helped to restore household wealth, especially in the U.S. and U.K.

Exhibit 3: Economies on the Comeback Trail?



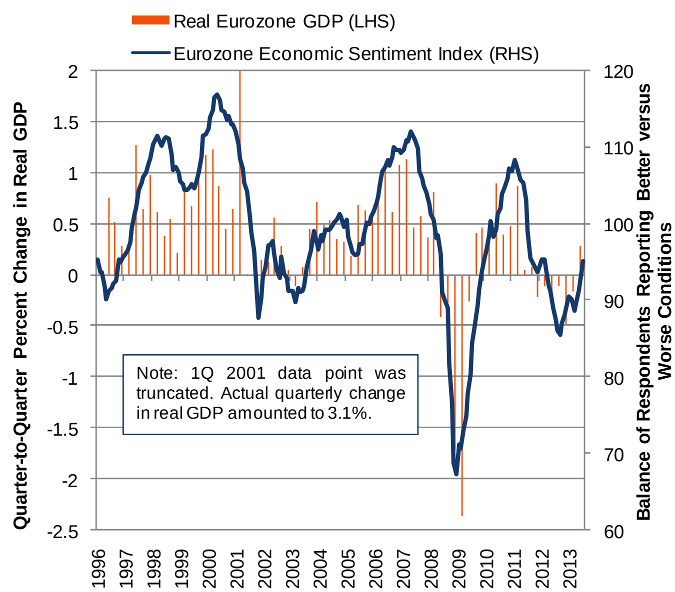
Source: FactSet, SEI

Of course, QE has its costs. First, investors have searched desperately for yield, bidding up risky assets with relatively high yields to unsustainable levels. Second, the present value of pension liabilities has been aggravated by persistently low bond yields. Third, artificially low yields have contributed to the expansion of equity price multiples, although we do not believe that valuations have reached dangerous levels. But most nagging of all for those of us with a free-market bias is the view that the artificial suppression of yields could lead eventually to some sort of financial bubble or economic imbalance. Granted, few policymakers really share that concern at a time when boosting economic growth is the primary economic objective. The unintended consequences of today's monetary policy choices will be the primary concern for another day.

Still Skeptics on Eurozone Growth

It feels good when the beating stops, hence the flurry of excitement over the less-bad economic data coming out of the eurozone. Thus far, the bulk of the improvement has come in consumer- and business-sentiment numbers and in the purchasing-manager surveys. "Harder" economic data—industrial production, retail sales, employment, trade flows—also appear to be stabilizing but are not quite as buoyant as the surveys that track economic change less rigorously. Granted, the surveys provide an early and important read on the direction of economies. As Exhibit 4 highlights, surveys such as the Eurozone Economic Sentiment Index can closely track the changes in GDP. But these surveys are indicative of current activity, not future activity.

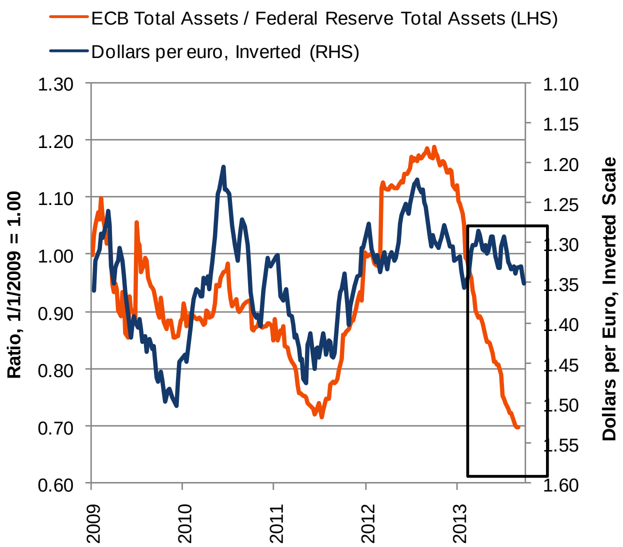
Exhibit 4: Green Shoots Appear in the Eurozone



Source: European Commission, Eurostat, SEI

Interestingly, ECB President Draghi has recently tended to play down the signs of economic improvement in the eurozone. Given the relative tightness of monetary policy, the parlous state of the region's banking system, and the ongoing (and steepening) decline in lending to businesses, we believe the ECB must chart a different course if Europe is to enjoy a sustained recovery of even modest proportions. The ECB's contracting balance sheet discussed above is contributing to the euro's strength against the dollar and the yen, in our opinion. Exhibit 5 on the following page compares the change in the ECB's balance sheet to that of the Fed. In recent years, there has been a strong relationship between the deviations of the central banks' respective balance sheets versus the relationship of the dollar and the euro. When the ECB's balance is expanding faster or declining more slowly than that of the Fed, the euro tends to weaken. When the opposite occurs, as is the case now, the euro tends to be pressured higher.

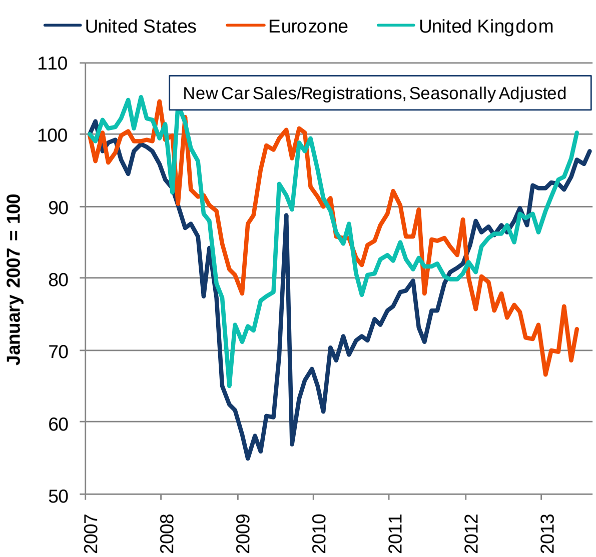
Exhibit 5: The ECB Is Too Tight; the Euro Is Too High



Source: European Central Bank, Federal Reserve Board, SEI

A strong euro is the last thing Europe needs. It threatens to undermine the nascent recovery—assuming there really is one. Merchandise exports in the eurozone through July were no higher than they were in the first half of 2012. Retail sales have moved up off their lows but remain in a broader downtrend that began three years ago. Car registrations, meanwhile, continue to bounce along at exceedingly depressed levels, lagging both the U.S. and the U.K., as shown in Exhibit 6. Industrial production in July hit its lowest point since early 2010.

Exhibit 6: Eurozone Car Sales Left in the Dust



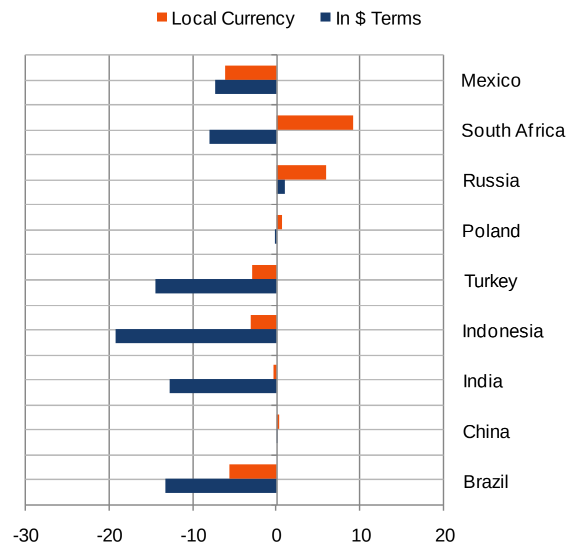
Source: U.S. Bureau of Economic Analysis, Organisation for Economic Co-operation and Development, SEI

We contend that the eurozone will continue to labor in the absence of a more expansionary monetary policy. Sustained growth will be next to impossible without growth in money and credit. Draghi is right to downplay Europe's "green shoots."

Unhappy Emerging Markets

Turning to emerging markets, we have seen significant improvement in equity performance since the end of August. China and Russia have broken into positive territory on a year-to-date basis in both dollar and local-currency terms, as highlighted in Exhibit 7. Brazil also has rebounded nicely off the lows, but it remains a very poor performer since the start of the year (-13.3% in U.S.-dollar terms). Outside of the BRICs we continue to still see a fair amount of pain, although the past month has recorded sharp recoveries in a variety of markets. Mexico and Indonesia—two examples of formerly hot markets—are down sharply from their pre-taper-talk highs in May.

Exhibit 7: Submerging Markets



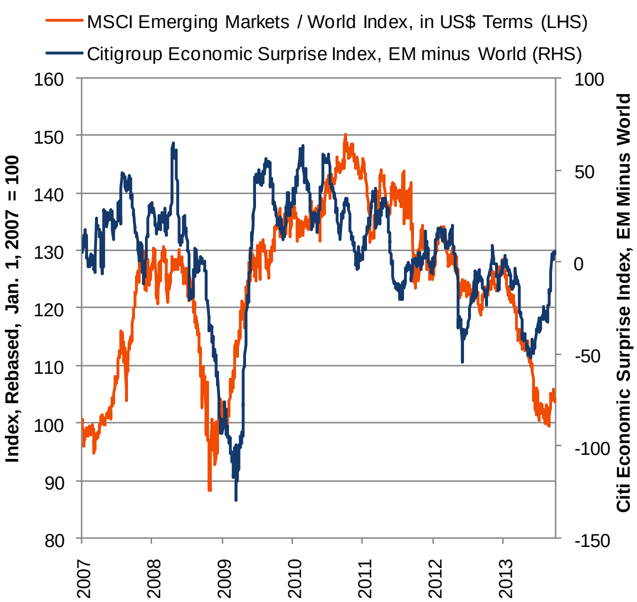
Year-to-Date % Change in MSCI Country Index (Total Return)

Exhibit 8 on the following page provides one reason for the generally better tone in emerging-market stocks recently. It juxtaposes the relative performance of the MSCI Emerging Index to the MSCI World (Developed) Index against the difference in the two regions' Citigroup Economic Surprise Index. You can see that the relative strength of the emerging-market countries (the orange line) peaked way back in 2010 following the emerging markets' explosive run out of recession led by China. This downtrend in emerging-market relative equity performance accelerated in early 2013, well before QE taper talk began. In recent months, emerging-market relative strength has stabilized and moved higher. Although the emerging economies are still laboring, the economic news flow is starting to improve, as indicated by the upswing in the relative Citigroup Economic Surprise Index (the blue line).

Emerging-Market Outlook

Some Wall Street analysts have argued that emerging-market equities and bonds have been victims of all the taper talk. There may be some merit to that, but it's certainly not the whole story. Retail investor flows out of emerging markets have been substantial in recent months. Institutions, on the other hand, seem to be increasing their emerging-market equity exposure. In our view, economic fundamentals have been far more important than investors' expectations surrounding the QE taper. Emerging-market economies and markets have been struggling for far longer than the months since May. As those economies begin to stabilize—China, for example, has been publishing more upbeat numbers lately—emerging-market assets should respond in positive fashion. According to State Street Global Markets, which tracks the holdings and trading activity of institutional investors, emerging-market currencies and equities appear to be underowned and undervalued. We tend to agree.

Exhibit 8: As Emerging-Market Economies Recover, Equities Should Follow



Source: Citigroup, MSCI, SEI

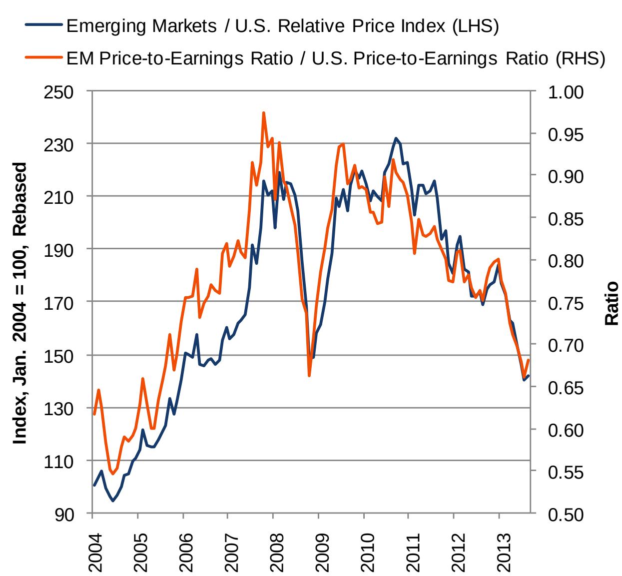
Unfortunately, it is very difficult to make blanket statements about emerging-market economies. Brazil and India have been facing a serious stagflation problem, forced to raise interest raise rates even as growth slows. China is undergoing a difficult transition from an investment-intensive, export-oriented economic model to one that is more focused on consumer and domestic demand. Even the Russian equity market, which should be enjoying strong capital inflows, thanks to buoyant energy prices, has been moribund owing to investor distrust over its politics and weak corporate governance.

Geopolitical concerns in the Middle East, sluggish global growth, speculation that the decade-long commodity "super-cycle" is coming to an end and concerns that rising interest rates in the U.S. and other developed countries will reduce investors' risk appetite for emerging-market securities all seem to be legitimate reasons to stay bearish on emerging markets. The question is, "Is it already reflected in prices?"

To evaluate this, we ask the following: First, is sentiment truly at an extreme? Second, are the poor fundamentals fully recognized or even misinterpreted by the consensus? Third, is there a catalyst for change?

One of the positives is valuation. By our reckoning, emerging-market equities are no more expensive than they were in 2009; they appear especially cheap against U.S. equities (see Exhibit 9). Of course, during the Asian debt crisis of 1997 to 1998 and the technology bust of 2000 to 2001, emerging markets got a lot cheaper than they are now. We would say that value currently is in the process of being restored in emerging markets, but a catalyst is necessary before the asset class comes back in favor in a big way. In the meantime, it is worth noting that correlations within the emerging-market world have declined considerably, both at the country and industry level. This opens up a great deal of alpha potential for active managers.

Exhibit 9: A Value Reconstruction Project



Source: MSCI, SEI

So what can be the spark to get emerging markets back on track? Let's talk about some of the more important ones that would have major regional and global implications.

- **China and global growth**

As the biggest importer of many important commodities, we need to see China's economy and financial system achieve a successful rebalancing. Business activity has slowed dramatically since 2010. The official numbers for GDP show that growth has decelerated to 7.6% over the past year through June. The country's challenges are well known, and a slowdown in China hurts the economies of other big exporters, putting further negative pressure on global economic activity and commodity prices.

There has recently been a quickening of the pace of growth in China, with a particularly large gain in electricity production in August. The composite purchasing managers' survey also moved higher in the latest report (September). This is consistent with the recent improvement seen in developed economies.

- **Economic reform and finances**

China also faces internal challenges as it tries to move toward a more balanced economic model that improves its citizens' standard of living. While the task is difficult, SEI is optimistic that this new leadership is determined to make it happen. A focus on corruption and efforts to put into place much-needed social reforms have started.

The instability of the Chinese financial system is a near-term concern. In June, we saw the Shanghai Interbank Offered Rate spike higher, as the People's Bank of China purposely engineered a mini-crunch. We're not sure the central bank succeeded in slowing speculative lending. Overall lending is still very strong, and so-called social financing jumped sharply in August.

It's estimated that total fundraising by Chinese non-state entities (think "shadow-banking system") amounts to 200% of GDP. That's up from 130% just five years ago. This increase in leverage is obviously concerning. One mitigating factor, however, is the reality that almost all borrowers and lenders in China are either connected to the public sector or are backstopped by the central government. The government has the ability and the motivation to come to the rescue if trouble erupts. By contrast, the household sector has very little debt on its balance sheet. The lack of a strong social safety net encourages an extraordinarily high household saving rate. This also reduces the danger of a big property bust. According to The Bank Credit Analyst, a third of all properties are bought with cash. When mortgages are assumed, down payments usually amount to 25%-to-50% of the value of the property.

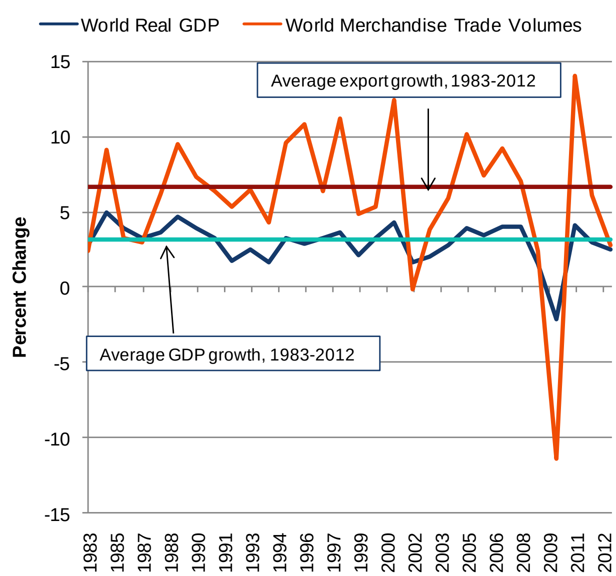
Obviously, the bullish case on China depends on the government's ability and willingness to recapitalize the banking system. It has the ability and, we think, it also has the will. There is no desire to throw the country into a severe downturn. The longer term bullish case for emerging-market investments will hinge on the Chinese government's ability to nudge the country's opaque financial system toward a healthier and more sustainable position.

- **Trade pacts**

The moribund trade talks conducted under the auspices of the World Trade Organization (WTO) have been eclipsed by the trans-Pacific and trans-Atlantic discussions championed by the U.S. These talks are better than nothing and could spark a revival in trade if successful. The Trans-Pacific Partnership initiative could be particularly important, since Japan has recently agreed to participate (although China hasn't). Now that the upper-house elections are behind Japanese Prime Minister Abe, it is time for him to make another grand gesture and open up his country to agricultural products. This would be helpful, not only to the U.S., Australia and Canada, but also to Brazil, Korea, Thailand and Vietnam—countries that have highly competitive agricultural sectors.

Trade has consistently grown faster than global GDP throughout the post-World War II period, as tariffs and other trade barriers were reduced and more countries were integrated into the world economy. Since the accession of China into the WTO in 2001, and the shift of fixed asset investment into the lower cost emerging markets, this trend swung into a higher gear. Since the 2007-to-2009 recession and financial crisis, however, both trade and global-GDP growth have slowed dramatically (Exhibit 10). In 2012, the volume of trade only matched the growth in global GDP—with both well below their historical rates of change. Previous broad-trade agreements have helped re-energize trade flows. A successful conclusion to these more focused efforts could be the catalyst investors are looking for.

Exhibit 10: More Trade, More Growth



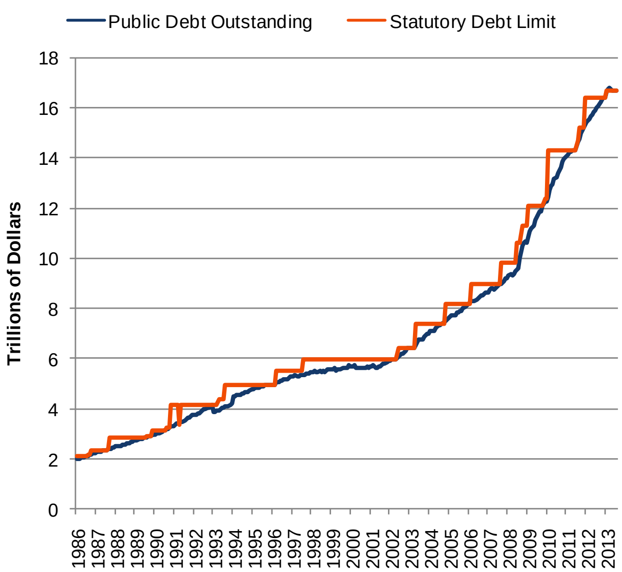
Source: International Monetary Fund, SEI

Beware the Ides of October

The stellar performance of developed-market equities this year has pushed stock price multiples to elevated levels. One-year forward-price-to-earnings ratios currently exceed 14 in the U.S. and are above 12 for slower growing Europe. As we said earlier in this report, these valuations are not at nosebleed levels. However, they are high enough to leave equities vulnerable to a price correction in the face of unexpectedly bad news. Unfortunately, possible bad tidings between now and year-end could give equity markets a nudge downward.

At the top of the list are the political games being played in Washington, DC over the 2014 fiscal-year budget, the debt ceiling and the spending sequester. The fight in September over the funding of Obamacare and the threat of a partial shutdown of government activities at the start of the fiscal year on October 1 were the prelude to a more serious battle over the debt ceiling. The Treasury's authority to borrow funds will run out around the middle of October, as Exhibit 11 shows. While the odds still favor a last-minute solution, the intense partisanship between Democrats and Republicans as well as between the House of Representatives and the Administration makes compromise extraordinarily difficult. The resilience of the U.S. stock market suggests that investors are assuming that things will work out in the end; but as the deadline approaches, increased volatility would not be surprising.

Exhibit 11: Debt Ceiling Redux



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

It's also possible that any agreement on the debt ceiling will be a temporary one that will extend only until the end of this calendar year. This would allow for additional negotiation and provide a path toward a grander compromise that includes funding of the budget, a debt-ceiling increase for the entire 2014 fiscal year and a modification of the sequester in exchange for entitlement reform. Bear in mind that this is conjecture. No one really knows how it will play out, but it is clear that no responsible politician wants to throw the economy into disarray by allowing a technical default of the government. Memories of 2011 are still too fresh. While a price correction of more than 5% in the S&P 500 Index could occur as the budget drama unfolds, our strategy would be to buy on the dip.

Active Positioning

The Fed's decision to delay tapering its bond buying provided a near-term boost to equity and bond prices, weakened the dollar and helped extend a rally in emerging-market assets and currencies. In this report three months ago, we thought that markets would stay on a choppy course. We have no reason to change that view.

Investor attention has now turned to the game of chicken playing out once again in Washington. The odds of a mild-to-moderate price correction in equities have increased, in our estimation. A recent stress test was conducted on our portfolios by SEI's Risk Management team to see what the "typical" client experience would be in a repeat of a 2011-style debt-ceiling impasse scenario. Looking only at the alpha (excess return) impact, our domestic equity portfolios could be expected to perform more or less in line with the broader equity market. An underweight to financials and overweight to technology should prove helpful, as well as short positions in selected currencies, including the euro and the yen. Our equity managers are still positioned for a muddle-through scenario—away from deep cyclical and defensive names, and focusing on less economically sensitive companies.

A flight-to-safety effect would likely prove more challenging for our fixed-income positioning (again, from an alpha-only perspective). The largest losses would be attributed to our exposure to leveraged loans, collateralized loan obligations and short-duration positioning.

With regard to our active asset allocation strategies, we remain short the euro and the yen. As explained above, the recent appreciation of the euro, counter to our expectations as a result of the extension of QE, has not changed our view that the currency is stronger than can be sustained. In addition, we have established an overweight position in emerging-market equity, using U.S. large-cap equities as a source of funds. Emerging markets have suffered sharp price declines, not just in the year-to-date, but also over the past two years. The resulting underperformance against the S&P 500 Index amounts to 30 percentage points in U.S. dollar terms. We seek exposure to emerging-market currency movements, on the assumption that improved emerging-market equity and currency performance will go hand in hand. This position also should bring diversification benefits to the short euro and yen trades currently in place in selected mandates.

Index Definitions

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 **Citigroup Economic Surprise Indices** are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases versus Bloomberg survey median).

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

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

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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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