Economic Outlook

Third Quarter 2014

A New Chapter Begins

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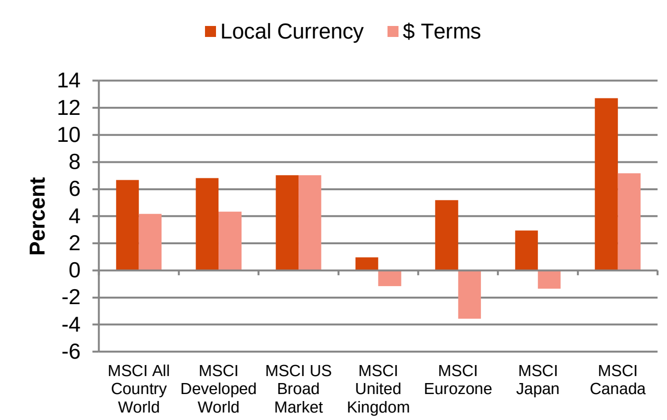
The past three months have been eventful for investors, both politically and economically. Politically, we have seen a deepening of the Russia-Ukraine crisis, the emergence of the Islamic State as a force to be reckoned with, a Scottish separatism scare that could have longer-term ramifications for the U.K., and a reshuffling of the French government as President Francois Hollande desperately seeks to improve his country's economy and his own popularity.

Economically, central banks seem to be trading places; the U.S. Federal Reserve (Fed) and the Bank of England (BoE) are edging closer to tightening their policies, while the European Central Bank (ECB) is now apparently willing to do "whatever it takes" to get the eurozone headed in the right direction. If you throw in the impact of recent electoral shifts (India) and major elections in Brazil and the U.S. (in October and November, respectively), one has the makings for an interesting market dynamic heading into the end of the year.

Oddly, equity markets have not been unduly affected by these complex cross-currents. As Exhibit 1 shows, equity markets across the globe have continued to climb.

Exhibit 1: Equity Prices Continue to Climb

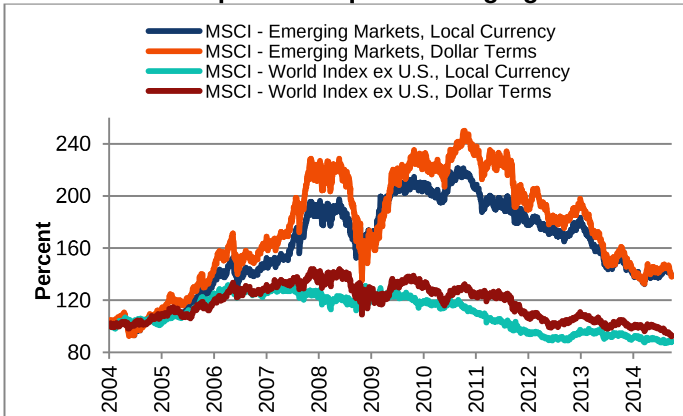


Total Return Indexes, Year-to-Date Percentage Change
Source: MSCI, SEI

The MSCI All-Country World Index, encompassing both developed and emerging markets, rose 6.7% year to date (through September 30) in local-currency terms. The U.S. continues to be a leading market, posting a total return of 7.0%. Canadian equities (up 12.7% in Canadian dollar terms and 7.2% adjusted for currency fluctuations versus the U.S. dollar) have been considerably stronger this year, driven by surprisingly strong profits growth. The U.K., on the other hand, has been one of the weaker components of the World Index, hurt earlier in the year by a strong currency. Although sterling fell sharply against the U.S. dollar in the run-up to the Scottish referendum, it continues to strengthen against Europe. Elsewhere, the eurozone has trailed the U.S. for the year to date by a relatively modest amount in local-currency terms, but significantly lagged when those returns are translated into dollars. Like Japan and the U.K., the MSCI European Economic and Monetary Union (EMU) Total Return Index is in negative territory for the year to date when translated into dollar terms.

From a multi-year perspective, U.S. equities have been outperforming both the MSCI (developed country) World ex U.S. Index and the MSCI Emerging Markets Index since at least 2010, whether measured in U.S. dollar or local-currency terms. Exhibit 2 highlights the results.

Exhibit 2: U.S. Equities Outpace Emerging Markets



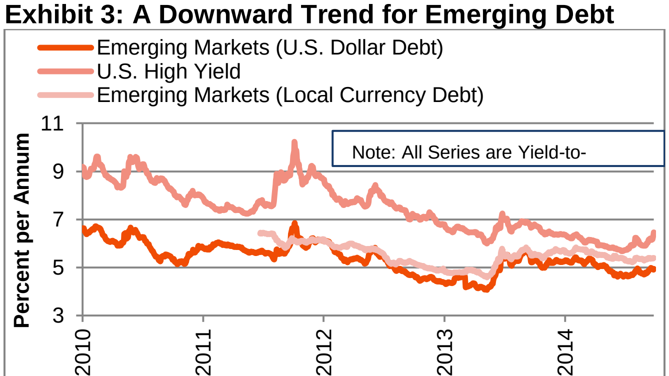
Sources: MSCI, SEI; Re-Indexed, Jan 1, 2004 = 100
All Series Measured Relative to MSCI-USA Total Return Index

Relative to U.S. equities, the MSCI World ex U.S. Total-Return Index has fallen to new lows. Emerging markets, meanwhile, are languishing near levels not seen since 2005 (except for a brief period at the height of the financial crisis in October 2008). While economic fundamentals and corporate profitability have been stronger in the U.S. than in most other countries, it's certainly reasonable to question whether this trend of relentless U.S. equity outperformance will continue. To be sure, we remain bullish on the U.S. equity market in terms of our expectations for continued stock price increases. In addition, given the upward momentum of the greenback, dollar-based investors may continue to see the U.S. equity market maintain its value against other stock markets over the next several months. But, in terms of local-currency performance, there is now more reason to expect a bend in the trend.

In fixed-income, global government bond yields[1] have been mainly range-bound; although European countries like Germany and France have seen shorter-term bond yields dip into negative territory. Meanwhile, the yield on 10-year Spanish bonds has recently traded under that of U.S. Treasury bonds, owing to declining consumer prices in Spain over the past year. It's hard to believe that bondholders are willing accept the bond of a country that only three years ago seemed to be going bust.

While sovereign bonds continue to see strong demand from investors, the riskier side of fixed-income—high-yield debt—has seen an increase in volatility. The yield on U.S. high-yield debt, as represented by the Barclays U.S. Corporate High Yield Index, has risen by more than one-half of a percentage point since the end of August to about 6.50%. That's the highest reading in nearly a year. Interestingly, emerging-market debt has not responded as dramatically. Yields on emerging-market government debt remain below levels that prevailed at the start of 2014, for both dollar- and local-currency issues, as Exhibit 3 shows.

Exhibit 3: A Downward Trend for Emerging Debt



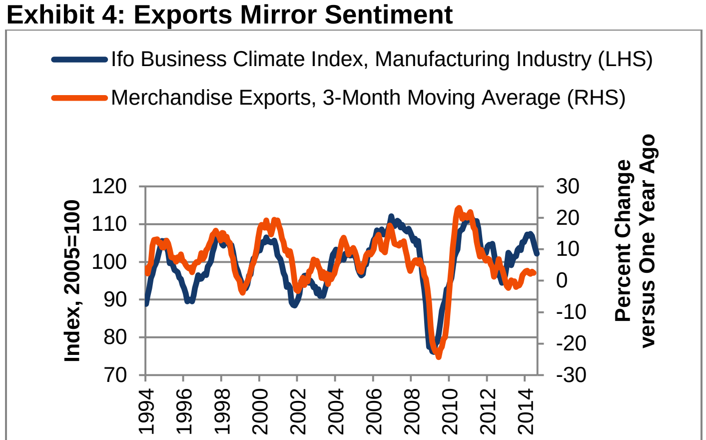
Source: Barclays US Aggregate Credit – Corporate - High Yield, Barclays Emerging Market Local Currency Government, and Barclays Emerging Markets (USD)

[1] Yield is a general term for the expected return, in percentage or basis points (one basis point is 0.01%), of a fixed-income investment.

Is Europe Getting Its Act Together?

We're not sure if eurozone equities are ready to take off, but there is hope for improved relative performance against the U.S. and other developed-country markets for the first time in years. It can be safely said that investor expectations for the region are extremely low. Of course, this jaundiced view is biased by repeatedly dashed hopes for economic recovery over the past several years. As recently as earlier this year, investors and economic commentators hailed signs of recovery in various surveys of economic sentiment and activity. As SEI noted at the time, however, the "hard" data (e.g. industrial production, retail sales, capital expenditures, exports) were failing to keep pace. Take Germany, for example. The country's Ifo Business Climate Index bottomed out in mid-2012 (around the same time ECB President Mario Draghi came out with his pledge to do whatever was needed to protect the euro and the integrity of the eurozone) and rose smartly into May of this year, as shown in Exhibit 4. Yet Germany's exports lagged sentiment by a significant margin. As the chart illustrates, this is unusual as there typically is a close correlation between the two readings.

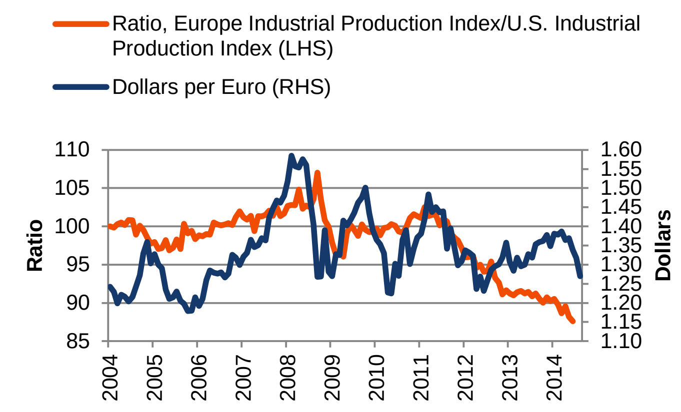
Exhibit 4: Exports Mirror Sentiment



Sources: Ifo National Institute of Research, Organisation for Economic Co-operation and Development, SEI

Of course, the appreciation of the euro from mid-2013 to March 2014 did not do German exporters any favors, no matter how productive or how well-engineered their products might be. The euro's climb created far more difficult economic conditions for less-competitive countries, particularly France and Italy. These two countries seemed to have stumbled into their third recession in six years. Note in Exhibit 5 that the eurozone's industrial production index accelerated to the downside versus U.S. production at the same time the euro started to climb against the dollar in mid-2013. The rate of descent in this ratio of eurozone-to-U.S. production is approaching the same rate that occurred from 2011 to 2012—when the region as a whole was indisputably in the midst of a double-dip recession.

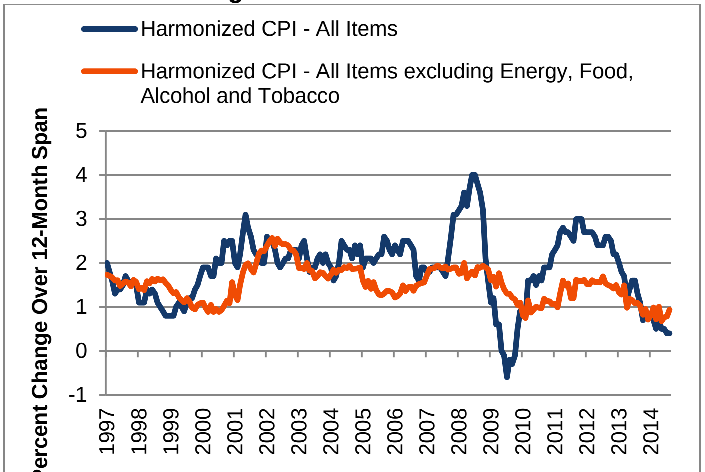
Exhibit 5: Eurozone Industrial Production Declines



Sources: Eurostat, Federal Reserve Board, WM Reuters/FactSet, SEI

Nascent optimism on the eurozone also has taken a beating as inflation continues to be pressured lower. The currency area's harmonized index of consumer prices (HICP) is now just 0.3% above the year-ago level for the region as a whole. In 2011, it was running around 3% year over year. Excluding energy and food, both of which have declined in price over the past year, eurozone inflation has been running closer to 0.7%. Nonetheless, this is still far from the ECB's inflation target of "under but close to 2%" (a goal the central bank has consistently failed to achieve since 2008, as shown in Exhibit 6).

Exhibit 6: Little Sign of Inflation in the Eurozone



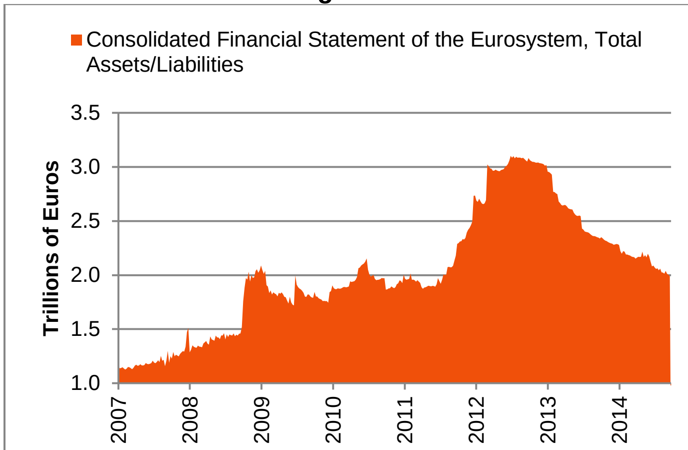
Sources: Eurostat, SEI

No individual country in the eurozone has a 2% rate of inflation. Although the core inflation rate has been range-bound for the region as a whole since the second half of 2013, Italy has experienced a sharp deceleration to 0.4% and Spain has been flirting with outright deflation by this measure. At the headline level, Italy, Spain, Portugal and Greece are all registering absolute price declines on year-over-year basis.

The renewed weakness in key economic data has generated a downward shift in inflation expectations that has been reflected in declining bond yields throughout the eurozone. Although benchmark 10-year bond yields have been easing in all the major developed markets lately, the drop in German bund rates has been eye-opening. The decline in bund yields below 0.9%—less than 40 basis points away from the yield on Japanese 10-year bonds and some 155 basis points below comparable U.S. Treasury bonds—has finally forced the ECB into a more-aggressive expansionary policy in defiance of German pressure to the contrary.

Not only has the ECB cut interest rates for the second time in three months, but it has also embarked on a course aimed at reversing the decline in its balance sheet (Exhibit 7) that impeded the region's credit recovery and helped keep the euro at elevated levels. President Draghi's pledge to bring the ECB's balance sheet back to levels that prevailed in early 2012 (a €1 trillion increase to €3 trillion) may not be as succinct as "do whatever it takes," but it could prove as important in reversing the economic trend of recent years.

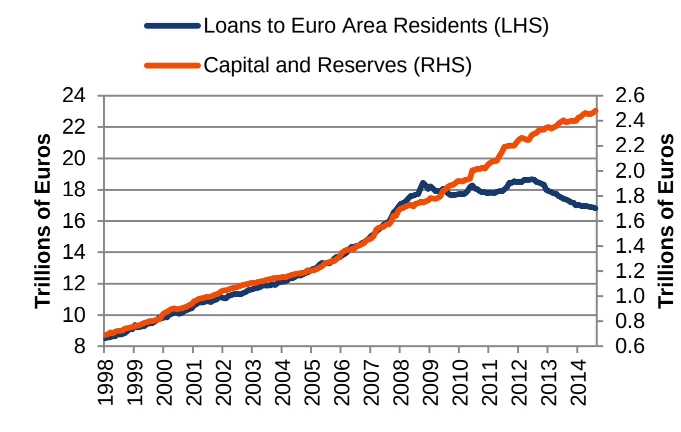
Exhibit 7: ECB Rebuilding the Balance Sheet



Sources: European Central Bank, SEI

Of course, the success of this effort is not guaranteed. The European banks are already awash in excess reserves. As Exhibit 8 shows, euro-area bank capital and reserves have grown significantly since the financial crisis in 2008, while bank loans to firms and households have fallen.

Exhibit 8: Aggregate Balance Sheet of Euro-Area Major Financial Institutions

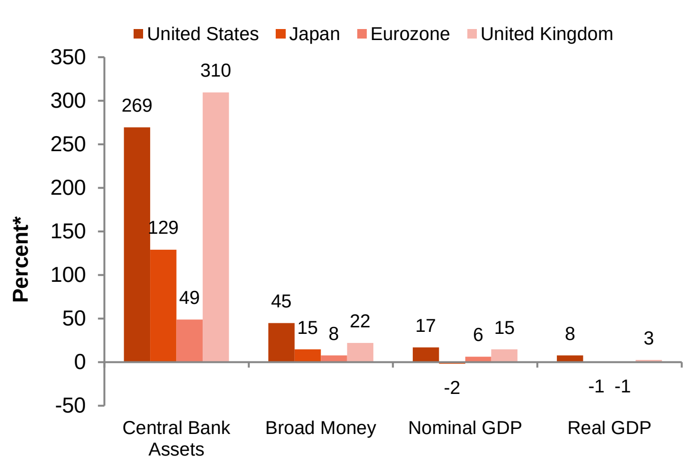


Sources: European Central Bank, Bank Credit Analyst, SEI

It is possible that financial institutions will respond to the lending incentives the ECB is putting into place once the region's asset quality review is published in mid-October and it becomes clearer which banks are well-capitalized. But the less-than-exuberant response to the initial offer of the Targeted Long-Term Refinancing Operation highlights the challenge facing the central bank in jump-starting the animal spirits of both lenders and borrowers in the eurozone.

Additionally, the experiences of the U.S., the U.K. and Japan show that a central bank must make a tremendous amount of bond purchases to generate even a mild improvement in economic activity. There is no denying that quantitative easing is a rather inefficient policy tool. Exhibit 9 shows the cumulative change in the assets of the U.S., Japan, the eurozone and the U.K. since the third quarter of 2008. The chart also highlights the impact of these quantitative-easing efforts on the broadly-defined money supply, nominal gross domestic product (GDP) and real (inflation-adjusted) GDP.

Exhibit 9: Central Bank Assets



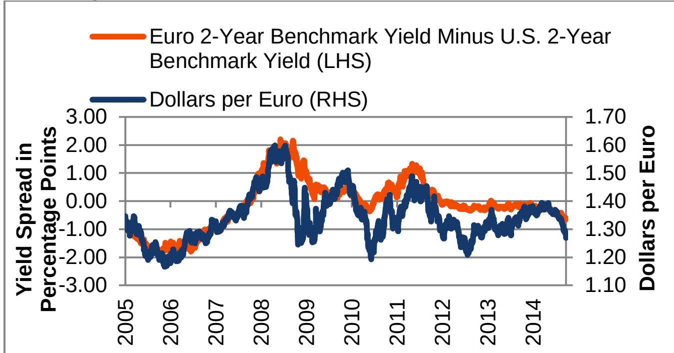
Sources: FactSet, SEI; *Cumulative percent change since fourth-quarter 2008

The two countries with the largest gains in central-bank assets—the U.S. and the U.K.—have also recorded the most gains in money supply and GDP (both nominal and real). But those gains are minuscule compared to the amount of bond buying that has occurred. The best that can be said of the aggressive use of quantitative easing by the Fed and the BoE in the early stages of the crisis is that it may have prevented their recessions from turning into depressions and avoided the prolonged economic agony we are still seeing in the eurozone.

We should not ignore the impact of fiscal policy, however, which was used aggressively in the U.S. as a countercyclical tool. While there have been big battles over whether all that spending was employed productively, it at least helped offset the collapse of private demand that occurred from 2008 to 2009. This contrasts sharply with the governmental austerity that exacerbated the decline in aggregate demand throughout the eurozone, especially in the periphery countries.

The bottom line: The ECB must be prepared to throw caution to the wind and do whatever it takes to grow its balance sheet, perhaps even beyond the levels already promised. Investors seem to be betting that this will happen. The euro has fallen sharply, even ahead of any actual change in direction of the ECB's balance sheet. Although no central bank would admit to manipulating currencies nowadays, we believe Europe needs a weak euro in addition to easier credit conditions, fiscal stimulus and structural labor-market reforms. A widening of interest-rate differentials in favor of the U.S. should help. As Exhibit 10 suggests, fluctuations in the value of the euro against the dollar are closely related to changes in the 2-year yield spread[2] between the two regions. The appreciation of the euro in the second half of 2013 and the first half of 2014, a time when the spread was turning decisively against Europe, was a policy mistake that is now being reversed.

Exhibit 10: Fluctuations in the Value of the Euro against the Dollar



Sources: Tullet/Prebon Information, WM/Reuters, FactSet, SEI

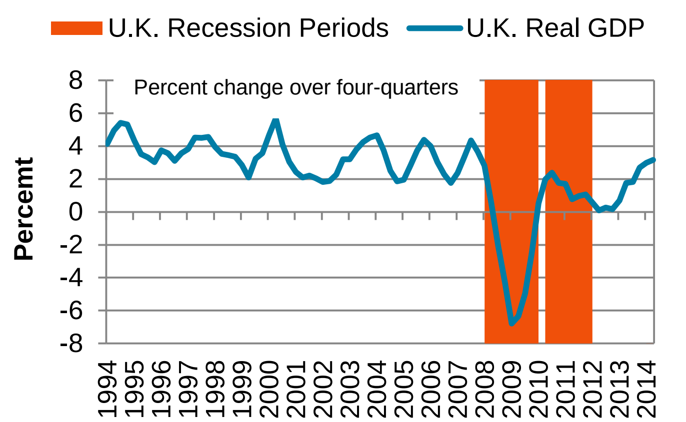
2 Spread is the additional yield, usually expressed in basis points, that an index or security offers relative to a comparable duration index or security (the latter is often a risk-free credit, such as sovereign government debt).

We expect that a sustained depreciation in the euro will lead to the same kind of upswing that was seen in expected 12-month earnings in Japan. While the yen's depreciation has not led to an export boom, much less a major increase in broader economic data, the stock market has responded to the currency-related rise in profits. The deflationary trend in consumer prices also appears to be in the early stages of reversal. Since the end of 2012, the Japanese stock market has advanced more than 60%, as measured by the MSCI Japan Total Return Index in local-currency terms, far outpacing Europe's 30% advance.

The Still-United United Kingdom

While the eurozone grapples with stagnation, the U.K has enjoyed one of the best economic performances among major developed countries. Business activity, as measured by inflation-adjusted GDP, has been running at an annual rate of about 3% since the middle of 2013, as seen in Exhibit 11.

Exhibit 11: Solid Growth in the U.K.

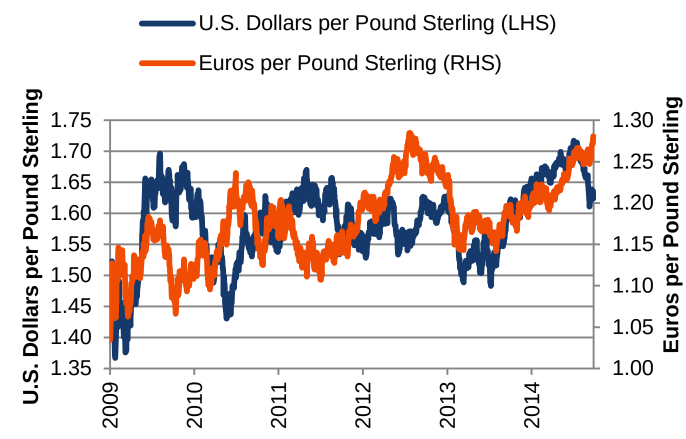


Source: Economic Cycle Research Institute (ECRI), U.K. Office for National Statistics (ONS), SEI

Household consumption has rebounded as the job market tightens—the U.K. unemployment rate fell to 6.1% in June, to around the same level as in the U.S. and a much lower level than the 11.5% in the euro area. Retail sales volumes reaccelerated significantly. Industrial production, on the other hand, has been rather sluggish, growing only 1.7% in the past year. Exports of goods and services fell in two of the past three quarters. The index of manufacturing purchasing managers also dropped rather sharply in recent months, consistent with the downturn in exports. Economic weakness in the eurozone, the U.K's most important trading partner, explains a large part of the deterioration in trade balance.

While U.K. exporters should benefit from the decline of sterling against the U.S. dollar, Exhibit 12 shows that the currency continues to appreciate against the euro. Indeed, sterling has climbed back to its mid-2012 high against the common currency.

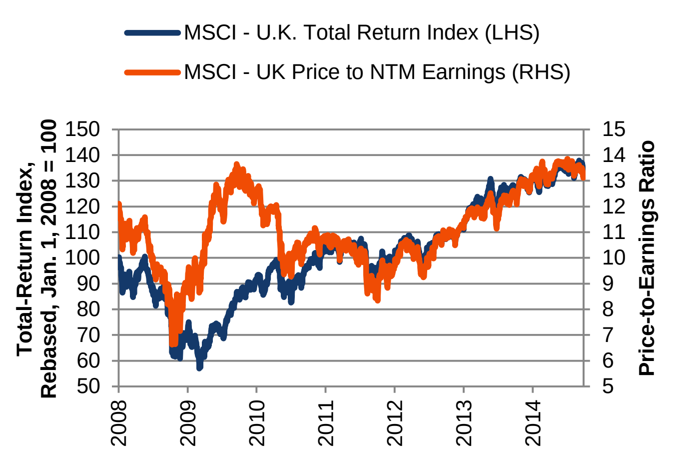
Exhibit 12: Sterling Dips vs. the Dollar, Up vs. Euro



Sources: WM Reuters/FactSet, SEI

This probably does not bode well for corporate profits in the coming year. We thus continue to see disparate trends in the U.K. Domestic consumption appears relatively robust, but the trade sector remains challenged. Since the country's equity market is dominated by export-sensitive industries, it should not be surprising that the MSCI UK Total Return Index is looking a bit rich, as seen in in Exhibit 13. With the MSCI U.K. Total Return Index forward price-to-earnings ratio at elevated levels and a less-than-convincing earnings turnaround, we find it hard to be a raging bull on U.K. equities.

Exhibit 13: Record Returns for the U.K.



Sources: MSCI, SEI

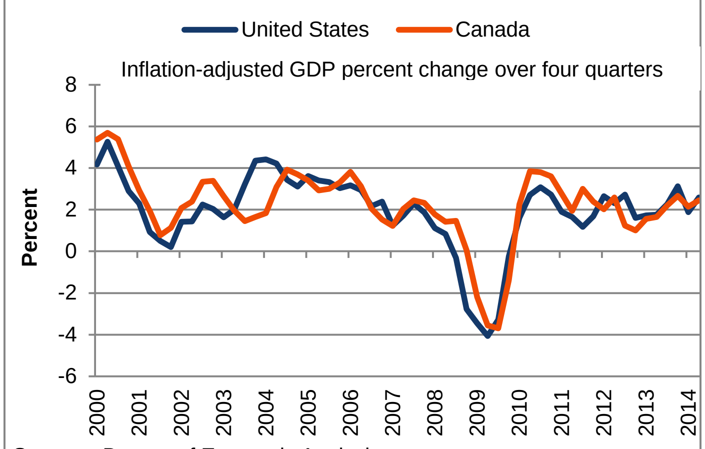
In light of the euro's decline against sterling, we have begun to question whether the first policy-rate hike by the BoE will occur as soon as many expect. To be sure, there are several reasons to expect the first interest-rate increase to come sooner than later: the relative strength of the U.K. economy; a somewhat frothy housing market (prices are up almost 12% nationwide over the past 12 months, while London is on another planet with a 19% jump); and a keen preference of some BoE governors to normalize economic policy as soon as possible are. However, inflation remains well under control and wage gains remain near cycle lows despite all the signs of economic growth. Even with the recent decline after the Scottish separatist scare, the trade-weighted exchange rate remains some 12% above its March 2013 reading. Since U.K. interest rates are well above those of Germany and France, and more in line with that of the U.S., a case can be made to delay the normalization process until the global economy (particularly the eurozone) appears to be on a stronger footing.

Increased domestic political uncertainty might also justify a go-slow approach. Although the Scottish referendum provided a decisive outcome, we can easily envision ongoing political pressure from the separatists in Scotland, as was the case for many years in Quebec, Canada. The promise of the U.K. government to devolve additional spending and tax authority to Scotland also opens up the debate regarding the proper role of the central government versus all the regions within the country, including Wales, Northern Ireland and England itself. The Scottish referendum may also serve as a prelude to how sterling and U.K. markets will react if a referendum on U.K. membership in the European Union (EU) comes up for a vote in 2017, as Prime Minister David Cameron promised (assuming that he is re-elected next year). If 45% of Scottish voters can turn their back on 307 years of shared history, one wonders how the U.K. electorate will vote on membership to a club that has always been viewed skeptically, to put it nicely.

As Good at It Gets?

As we noted at the start of this report, the U.S. and Canada have enjoyed relatively strong stock-market performances and decent, but hardly spectacular, economic fundamentals. Both countries are joined at the hip economically, with GDP growing at a similar pace over time, as highlighted in Exhibit 14.

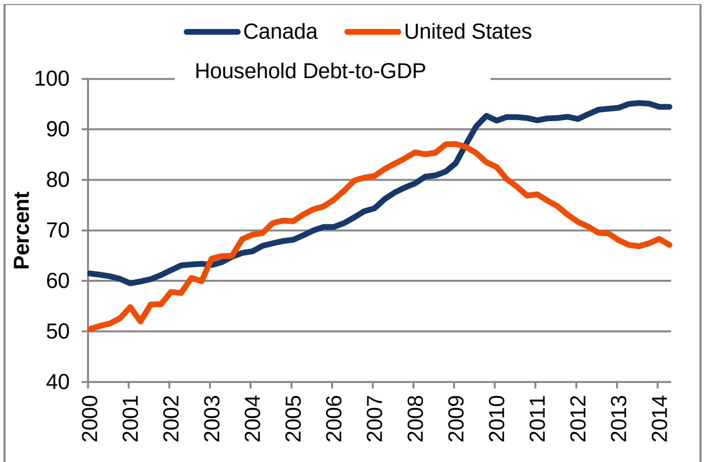
Exhibit 14: Close Economic Ties for North American Neighbors



Sources: Bureau of Economic Analysis, Statistics Canada, SEI

Policy rates also tend to move in the same direction, although the Bank of Canada raised its overnight target rate in 2010 in three stages to 1%, while the Fed kept the federal funds rate target at 25 basis points (the effective funds rate is just 9 basis points). This divergence in policy reflected the fact that Canada avoided the housing-debt debacle that hit households and financial institutions south of the border. Exhibit 15 shows that household debt is currently much higher in Canada than in the U.S. The housing market is far stronger too—perhaps worryingly so, as we pointed out in last quarter's Economic Outlook report. That said, we do not expect the Bank of Canada to increase its policy rate until the U.S. federal funds rate approaches 1%. Meanwhile, exporters should benefit from the weakening of the Canadian dollar against its American counterpart.

Exhibit 15: More Debt in Canada



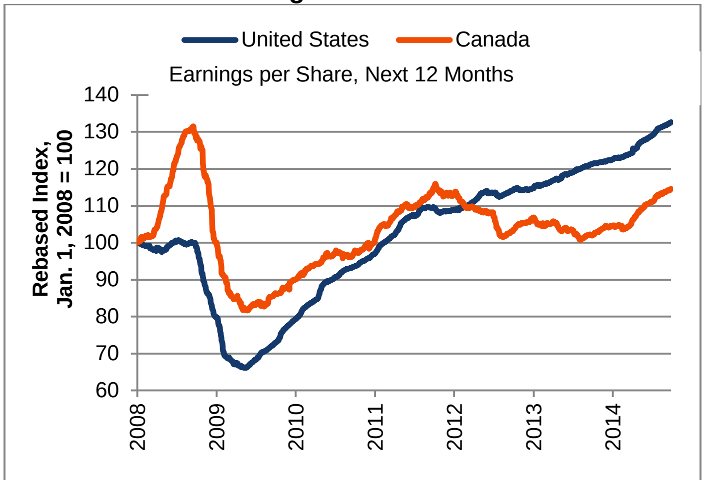
Sources: Federal Reserve, Statistics Canada, SEI

The U.S. is now edging closer to hiking its federal funds target rate, as labor markets strengthen and business activity appears increasingly capable of self-sustaining growth without the need for extraordinary central-bank intervention and financial repression. The exact timing of the first interest-rate increase in the U.S. remains a question mark, but most Fed watchers expect it to come around the middle of next year. Of more importance is the speed at which rates move higher. Views vary widely, even within the Fed. The so-called "dot plot" of each voting and non-voting member of the Federal Open Market Committee (FOMC) indicates that the median expectation is for a funds rate of 1.375% at the end of next year, 2.875% at the end of 2016 and 3.75% in 2018 and beyond. (The FOMC is composed of the Fed Board of Governors and regional Fed presidents.) Of course, their guesses are just as good (or bad) as the ones we and everyone else make. Fed Chair Janet Yellen has tended to downplay the forecasts made by the FOMC, repeatedly reminding us that Fed policy is "data-dependent." If the economy remains soggy, it's a pretty good bet that interest rates will remain lower for longer.

It would not be surprising if equities experienced some turbulence around the time the Fed begins to raise short-term rates. But history suggests that bull markets do not end with the first rate boost. On the contrary, according to Ned Davis Research, the average price-only gain in the S&P 500 Index in a year following an initial Fed policy rate increase amounts to 8.6%—with 13 cases of positive performance versus six periods of negative outcomes since 1928. This also contrasts with an average annual price gain of 7.2% for all buy-and-hold periods. Rising interest rates have the potential to shrink price-to-earnings ratios; however, this negative impact should be limited. The central bank will likely tighten monetary policy because the economy is strengthening. And, if the economy is strengthening, profits will probably rise.

Exhibit 16 shows that per-share earnings have been advancing at a good clip in both Canada and the U.S. The U.S. has had a smoother trajectory, but Canada has witnessed a nice acceleration in 12-month forward-earnings-per-share since the beginning of 2014. As in the U.S., stock multiples in Canada appear elevated, with the MSCI Canada measure at 15-times forward earnings. But strong earnings and revenues, combined with low inflation and interest rates, should mitigate near-term valuation concerns.

Exhibit 16: U.S. Earnings on the Rise



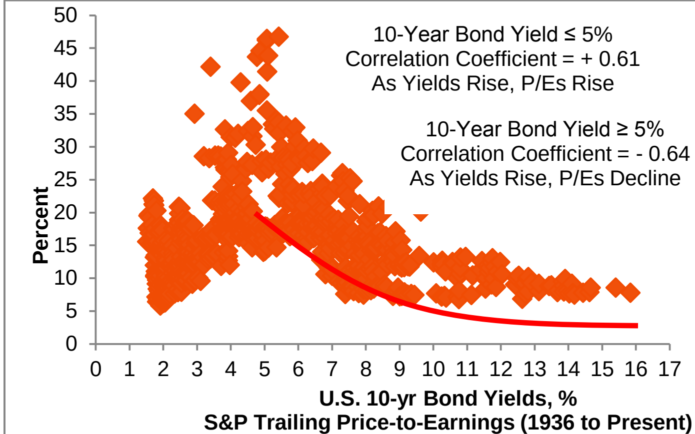
Sources: MSCI, SEI

We recognize that every interest-rate and economic cycle has its unique aspects. One can make the argument that the current cycle has more than its share. The economic recovery since mid-2009, for example, has been one of the weakest on record, from both domestic and global perspectives. Inflation pressures remain hard to find, with the exception of a few developing economies. In the absence of such pressures, the Fed has been slow to exit from its extraordinary policies. Quantitative easing will end in October, but the Fed has already promised to reinvest mortgage pay-downs of principal and interest back into the mortgage-backed securities (MBS) market at least until the funds rate begins to rise (and, we reckon, well beyond that time, given the state of the housing market). We believe an actual wind down of the Fed's Treasury and MBS portfolio holdings is a very distant prospect.

Central bank policy rates across major developed countries are starting at *de minimus* levels (and in Europe, as we have already noted, they have fallen to negative levels). As a result, the economic impact of the first few interest-rate increases should have little impact on economic growth. In the U.S., the funds rate will need to reach 2% before it even approaches a positive inflation-adjusted rate. Longer-term bond yields also remain near record lows throughout the major countries of the developed world, and well below the earnings yield on equities. Even if bond yields rise in sympathy with short rates, they would need to climb dramatically for stocks to fall in significant fashion.

Exhibit 17 compares the correlation between bonds and the trailing price-to-earnings ratio of the S&P 500 Index. It shows that the *level* of interest rates—not just their *direction*—is a key determinant of how equities respond to a rising trend in the yield on 10-year benchmark Treasury bonds.

Exhibit 17: Bond Yield Barometer Changes at 5%



Sources: RBC Capital Markets, Robert Shiller, SEI

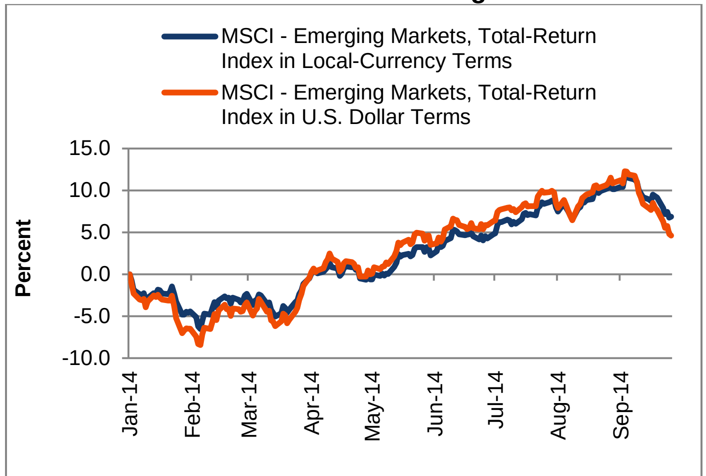
When bond yields are below 5%, the correlation between interest rates and stock multiples is a positive one. As bond yields increase, so do price-to-earnings ratios. In contrast, when bond yields are above 5%, the correlation tends to go negative. The higher bond rates go, the lower stock multiples are likely to be. We expect it will take a few years before bond yields breach 4%, much less the danger zone of above 5%.

In sum, the bull market in equities is entering a new, more mature stage. In the U.S., the stock market is likely to be less dynamic and choppier than we have seen in recent years. Yet, until the Fed considerably tightens policy and increases the odds of recession, the path of least resistance in equities should continue to be toward the upside.

More Headwinds for Emerging Markets

This has been a volatile year for emerging-market equities. The MSCI Emerging Markets Index is up 5.5% in local-currency terms in the year to date through September 30, but was as low as -6.8% in February and as high as 11.6% as recently as the beginning of September. The results in dollar terms have been even more volatile, as emerging-market currencies appreciate against the dollar during up phases and depreciate as the markets turn south (as seen in Exhibit 18) amid capital outflows.

Exhibit 18: Cumulative Percent Change Year-to-Date

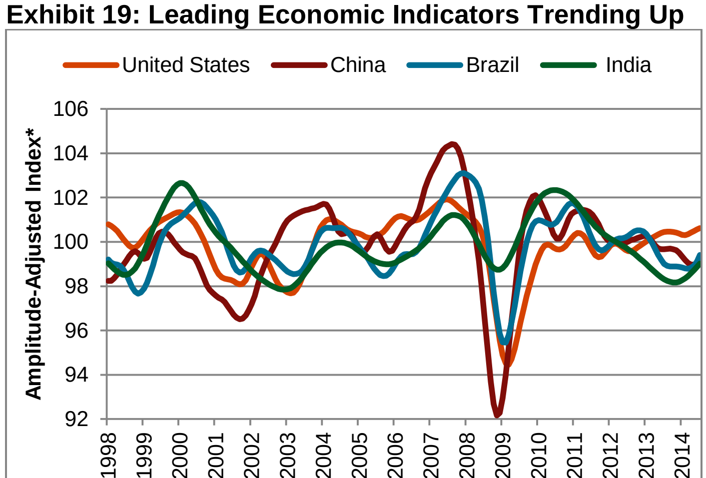


Sources: MSCI, SEI

The dollar's strength, the imminent end of U.S. quantitative easing, the economic slowdown in China and the ongoing weakness in commodity prices are some of the headwinds facing emerging markets as a group. Tensions in Ukraine, meanwhile, have hurt Eastern European markets in recent months. Meanwhile, economic and political uncertainties in Brazil, Venezuela and Argentina have cast a pall over equity markets in Latin America.

Of course, there are some bright spots. There have been signs of economic improvement in the leading economic indicators of India, Brazil and China (Exhibit 19); although all three remain below the 100 mark, indicating below-average growth.

Exhibit 19: Leading Economic Indicators Trending Up



Sources: OECD, SEI

*A reading above 100 and rising predicts expansion, above 100 and falling a downturn, below 100 and falling a slowdown and below 100 and rising a recovery.

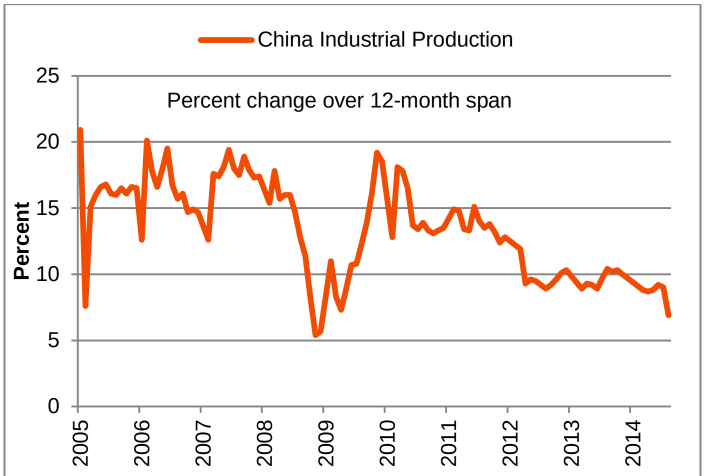
At this point, though, only India seems to be enjoying a convincing turnaround, helped in part by rising expectations that the government of Prime Minister Narendra Modi will be able to implement important economic reforms in the years ahead. Unlike Prime Minister Shinzo Abe in Japan, Prime Minister Modi is still enjoying a honeymoon period as he builds coalitions within the various Indian states. The goal is to create the conditions that allowed him to succeed when he governed the state of Gujarat. Investors certainly have responded: The MSCI India Index climbed nearly 25% in the year to date, in both local-currency and U.S. dollar terms.

Brazil's equity market, by contrast, is up only 1.2% in dollar terms in the year to date; as recently as early September, the MSCI Brazil Total Return Index was up by more 25%. Not only are investors skittish about the outcome of the October presidential elections, but the country's GDP registered a decline during the second quarter. Economists blame the World Cup, as it took people away from work, but the GDP decline is consistent with slowing consumption growth and the weak trend in investment since 2010. Although the unemployment rate is relatively low in Brazil, inflation has held stubbornly above 6%. This has forced the central bank to keep its target policy rate at 11% through much of the year—making it one of the highest policy rates in the world.

The first round of Brazil's presidential elections took place October 5. As expected, there will be a run-off election on October 26. However, incumbent President Dilma Rousseff will be facing the conservative candidate, Aecio Neves. Mr. Neves staged a surprisingly strong run late in the campaign to advance to the next round. Brazilians will be facing a stark choice between the two candidates' visions—Ms. Rousseff's emphasis on state-run capitalism versus the free-market focus of the challenger. If Mr. Neves pulls out a surprising victory, there will almost certainly be a sharply positive market reaction—as seen following the elections of Mr. Abe in Japan and Mr. Modi in India. However, as has been true in Japan and India, the ability to sustain an initially positive reaction will come down to challenging and bending the entrenched power structure in a new direction. In any country or culture, that is a hard thing to do.

Finally, China remains a source of concern for emerging-market investors. Industrial production fell in August to 6.9% on a year-over-year basis, its slowest pace since the economy was still near the bottom of the cycle in 2009. Exhibit 20 showcases the trend.

Exhibit 20: Production Declines in China



Source: National Bureau of Statistics (China), SEI

This deceleration in output appears consistent with that of electricity production and crude oil demand. Meanwhile, retail sales have also slowed and are now growing at an 11.9% annual rate, less than half the pace of 2010; home sales have slid 15% versus last year.

Economic policy (or at least central bank messaging) appears rather confused at the moment. Stimulus measures have been half-hearted, since China's government would prefer to rein in the country's debt rather than add to it. The central bank is trying to inject credit into the banking system in a measured way, which might alleviate typical end-of-quarter liquidity pressures that have driven up short-term interbank rates on a seasonal basis. On the other hand, there are signs that economic and financial reform efforts have slowed. The goal of redirecting China's economy toward increased household consumption and smaller, more-nimble private-sector providers of goods and services (and away from big state-owned enterprises that engage in heavy industry) was never going to be an easy affair. The need to deleverage following the lending boom between 2008 and 2009, not to mention the reining in of the shadow banking system, further complicates this transition.

We continue to think that the Chinese economy and financial system are corseted sufficiently for the government to achieve its near-term goal of an economic soft landing. But there likely will continue to be tension between opening up the economy in order to grow smarter and the tried-and-true method of lending indiscriminately in order to grow faster.

China remains the most important economic actor in the developing world. However, as long as the country is in muddle-through mode, trade in global commodities will remain relatively weak. Given the poor prospects for economic growth in much of the world, trade-oriented developing countries will continue to face a stiff economic challenge.

Where We Stand

It is our view that the global economic recovery is a work in process. The expansion in North America seems to be well-established. Equity markets in the U.S. and Canada reflect this relative economic strength. While the Fed is moving toward a normalization of monetary policy, with quantitative easing coming to an end, we expect a cautious approach when it comes to raising interest rates. As long as inflation pressures remain subdued, the focus will likely be on doing what it takes to boost employment and economic growth.

We expect U.S. equities to continue their upward trek, although that advance may become more sedate compared to past three years. Equity prices should advance more in line with profits. In other words, stock multiples should hold steady or, perhaps, shrink slightly even as profit growth accelerates on the back of an improving economy.

Better equity opportunities may exist outside the U.S., at least on a local-currency basis. Unfortunately, risks remain higher outside the U.S. too. It takes some nerve to be a bull on Europe, for example, given all its problems. But at least the first decisive steps have been taken by the ECB to improve market liquidity. An expansive monetary policy may not be sufficient to jump-start Europe's economic engine, but an upturn would be impossible without that stimulus. Currency markets have already responded, with the euro (finally!) cracking in a big way.

Japan may be a template for the eurozone: engage in quantitative easing, weaken the currency (while denying that is a policy goal), reverse the downtrend in inflation and hope animal spirits respond. Yet Japan also provides a cautionary tale. Unless accompanied by substantial structural and social reforms, the benefits from quantitative easing may not be sufficient to put the economy on a strong track. We hope to see both Japan and the eurozone do more in the year ahead to open their markets, push through additional labor-market reforms and generally increase the flexibility of their economies.

Emerging markets, meanwhile, remain a case-by-case proposition. There is still no tailwind from China that they can count on to raise commodity pricing and exports. It's possible that India and Brazil could take up that baton. But these are early days for the Modi government and we are awaiting the outcome of the elections in Brazil before we get our hopes up that India and Brazil will both have the political will and ability to shake up the status quo.

That said, we still think it is a world where equity markets are likely to outperform bonds. Bond yields are too low and credit spreads too tight to provide a lot of competition for stocks. It hardly needs to be said that bonds provide important diversification benefits versus more-volatile equities. But we are still comfortable in assuming that the equity bull market will be prolonged by the very fact that the economic cycle has been so subdued, keeping inflation pressures low and central-bank policies equity-investor friendly. Now that the ECB is joining the party, our confidence in the secular-bull scenario has gotten even stronger.

Strategy Positioning

Overall portfolio positioning suggests that investment managers in our strategies share a pro-U.S.-growth view. In general, portfolios across asset classes overweight the dollar, underweight the euro, favor small caps over large caps and tilt toward momentum and away from value. Equity managers in the U.S. are exposed to greater market sensitivity (betas[3] are higher than benchmark), while small-cap managers are favoring larger companies in their portfolios, thereby lessening exposure to volatility. Within our small-cap strategies, capitalization levels are the highest they have been in the past five years. This tendency to increase market-sensitivity in large-cap holdings and reduce it in small-cap holdings is consistent with the currently weaker fundamental position of small-cap companies versus large-cap companies. In addition, some of our managers expect the end of U.S. quantitative easing to act as a headwind for small-company stock prices.

In fixed-income, U.S. managers remain neutral on credit, although they continue to overweight financials and non-agency mortgages. Duration[4] also remains modestly shorter than the benchmark. There is a curve-flattening bias, underweighting bonds in the 2-to-5-year maturity range and overweighting long-term 30-year issues. In high-yield strategies, managers shortened the duration of their portfolios in recent months. Credit-quality positioning continues to overweight CCC and B rated debt versus BB credits. High-yield debt is expected to deliver coupon-like returns; however, there does not appear to be a catalyst for a dramatic widening of spreads at this time.

[3] Beta is a quantitative measure of the Fund's volatility relative to the benchmark used. A beta above 1 indicates the Fund is more volatile than the overall market, while a beta below 1 indicates a Fund is less volatile.

[4] Duration is a measure of a security's price sensitivity to changes in interest rates. Specifically, duration measures the potential change in value of a bond that would result from a 1% change in interest rates. The shorter the duration of a bond, the less its price will potentially change as interest rates go up or down; conversely, the longer the duration of a bond, the more its price will potentially change.

Internationally, equity managers increased their exposure to idiosyncratic risk—individual stock selection is becoming more important. Style exposures include overweight positions to momentum and volatility, an overweight to small-cap and an underweight to dividend payers. On a geographic basis, international managers are underweight the major developed markets, but have an overweight in emerging markets and an off-benchmark exposure to the U.S. Managers also have significant exposure to foreign-exchange risk, with short positions against the yen, euro, and Australian dollar versus long positions in the U.S. dollar and Norwegian krone.

SEI's portfolio managers still favor value-oriented risk-premium managers in Europe excluding the U.K., but favor momentum managers in the U.K. Cyclical sectors and non-bank financials are favored; defensive stocks are underweighted, as are banks, energy and commodity companies. Europe ex U.K has greater market sensitivity than its benchmark, while positioning versus the U.K. is more balanced. Fixed-income managers in Europe are short duration in U.S. Treasurys, U.K. gilts and German bunds in anticipation of a back-up in rates. They are overweight U.S. and EU corporate and high-yield bonds, with most of the risk coming from high yield and the EU. Our European fixed-income managers also favor the dollar versus the euro, the yen and Canadian dollar.

Canadian fund managers are also exposed to volatility and beta. There is meaningful long exposure to the U.S. dollar on the assumption that the U.S. currency will continue to appreciate against the Canadian dollar in the aftermath of quantitative easing and the onset of a rising U.S. rate trend in 2015. Canadian portfolios remain overweight the consumer and technology sectors, and are underweight energy and materials. The largest underweight can be found in the financial sector.

Managers in Asia continue to carry a large underweight in Australia, particularly the major banks (which have high valuations and a weak outlook). China is the largest overweight in these portfolios, on the expectation that investor sentiment toward the country will improve in line with the global economic recovery. There also is a cyclical exposure toward Japan, with an emphasis on momentum. Although the country's economic performance has been choppy, our managers are looking for additional structural reforms, both economic and with regard to corporate governance.

In emerging markets, the bulk of risk is idiosyncratic, reflecting the wide divergence of performance across countries, sectors and companies. Our managers are overweighting small-cap stocks. Similar to managers in other equity strategies, there is a bias toward momentum and volatility and an underweight toward value. Managers are overweight India and offshore Chinese companies. These managers believe that investor fears of a negative impact from a U.S. monetary policy tightening cycle are overdone. Emerging-market debt managers are underweight interest-rate duration and overweight spread duration, with little change in positioning over recent months. The biggest active country overweights include Indonesia, Venezuela, Russia, Brazil and Argentina. The biggest active underweights include Poland, South Africa, Philippines and Lebanon.

Within alternative strategies, allocations to the event-driven strategy have increased meaningfully in the past year against a favorable backdrop of low interest rates, modest momentum in the economy, restored equity prices of mergers and acquisitions (M&A) and high corporate cash balances. Record M&As have been driven by a resurgence of mega deals in recent months, with several $50 billion-plus proposed acquisitions. Additionally, corporate break-up and restructuring trends persist, whether pushed by activists or corporate boards acting independently. Against this backdrop, the strategy has performed well year to date and we believe the portfolio is well positioned for an event-rich environment. Equity hedge managers also have seen an increased allocation in the past year. More recently, SEI managers have begun to diversify away from relatively high equity exposures in anticipation of a return to higher volatility levels. We also hold a positive view on the relative-value space and believe the environment for credit selection is favorable right now. The recent increased volatility has led to significant dispersion between solid and weak credit profiles—creating a number of interesting trading opportunities for our managers. Securitized strategies also remain attractive amid improving fundamentals and attractive supply/demand dynamics. Finally, tactical/directional managers have benefited from rallies in the U.S. dollar, the Chinese remnimbi and Japanese equities.

Index Definitions

The Barclays U.S Corporate High-Yield Bond Index is composed of fixed-rate, publicly issued, non-investment-grade debt.

The MSCI All Country World Index is a market-capitalization weighted index composed of over 2,000 companies, and is representative of the market structure of 48 developed and emerging-market countries in North and South America, Europe, Africa and the Pacific Rim. The Index is calculated with net dividends reinvested in U.S. dollars.

The MSCI World ex-US Index is a free float-adjusted market-capitalization weighted index that is designed to measure the equity market performance of developed markets. The Index consists of the following 23 developed-market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the U.K.

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 the following 23 developed market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the U.K. and the U.S.

The MSCI All Country World Index ex-US is a free float-adjusted market-capitalization index that is designed to measure equity market performance in the global developed (excluding the U.S.) and emerging markets.

The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 emerging-markets countries.

The MSCI EMU Index (European Economic and Monetary Union) Index is a free float-adjusted market-capitalization weighted index that is designed to measure the equity market performance of countries within EMU. The MSCI EMU Index consists of the following 10 developed-market country indexes: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal and Spain.

The MSCI USA Index is a free float-adjusted market-capitalization index that is designed to measure large- and mid-cap U.S. equity market performance.

The MSCI United Kingdom Index is designed to measure the performance of the large- and mid-cap segments of the U.K. market.

The MSCI Japan Index is a free float-adjusted market-capitalization index that is designed to measure the equity market performance of the developed markets in Japan.

The MSCI India Index is designed to measure the performance of the large- and mid-cap segments of the Indian market.

The MSCI Canada Index is designed to measure the performance of the large- and mid-cap segments of the Canada market.

The MSCI Total Return indexes measure the price performance of markets with the income from constituent dividend payments. The MSCI Daily Total Return (DTR) Index Methodology reinvests an index constituent's dividends at the close of trading on the day the security is quoted ex-dividend (the ex-date).

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. Current and future portfolio holdings are subject to risks as well. Diversification may not protect against market risk. 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. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. 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.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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