Economic Outlook

First Quarter 2015

Bonds in Bizarro World

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- The U.S. bull market appears to be intact and any correction associated with the start of an interest-rate up-cycle is expected to be limited.
- The European Central Bank's sovereign bond purchase program is a much larger initiative in terms of net new supply than programs put in place by other central banks since the crisis.
- Nearly $1.5 trillion of European bonds are trading with a negative yield-to-maturity. In Germany, negative yields extend out to seven years.

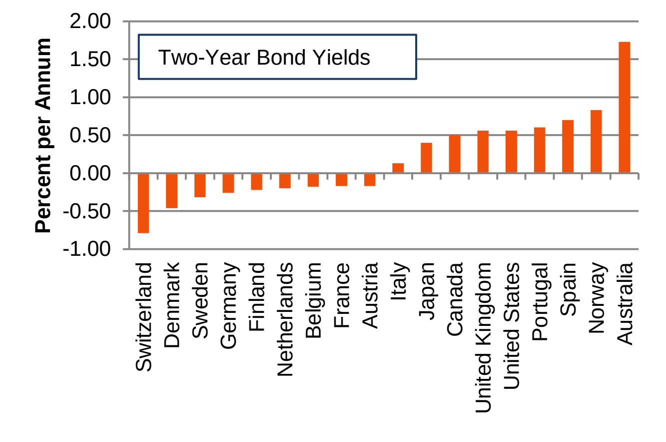
Aficionados of the Superman comic magazines from the early 1960s (or, for that matter, comedian Jerry Seinfeld of a more recent vintage) will recognize the reference. Bizarro World was a very strange place, basically the antithesis of Earth. In fact, the planet's name was Htrae—"Earth" spelt backwards. The cube-shaped planet was populated by flawed clones of Superman, Lois Lane and other characters from that comic strip. Bizarro World was ruled by the following code: "Us do opposite of all Earthly things! Us hate beauty! Us love ugliness! Is big crime to make anything perfect on Bizarro World!"

We thought of Bizarro World because there is actually one frame in the series which shows a Bizarro Superman clone doing a booming business selling bonds on a street corner. He's yelling "Buy Bizarro bonds! Guaranteed to lose money for you!" Somebody in the crowd yells back, "Me take 5! What a bargain!" Meanwhile, Bizarro #1 (the original clone of Superman), chokes back tears because he doesn't have enough money to buy the bonds that will lose him money.

Bizarro World doesn't seem that bizarre anymore. Buy German bunds! Guaranteed to lose money for you! Perhaps Germany should be renamed Ynamreg…

Amazingly, Germany is not the only country issuing sovereign debt securities with negative nominal yields nowadays. Nearly $1.5 trillion of bonds in Europe are trading with a negative yield-to-maturity. As Exhibit 1 highlights, two-year notes trade in negative-yield territory in at least nine developed European countries. Portugal, Spain and Italy—periphery countries that sported yields as high as 19.4%, 6.6% and 7.5% on their respective two-year notes a few years ago—are now close to turning negative too.

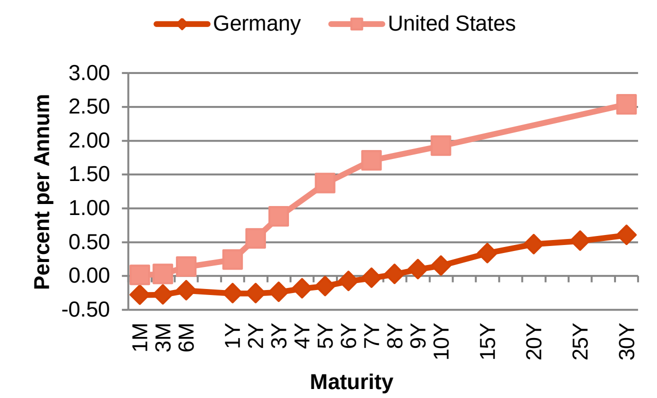
Exhibit 1: "Guaranteed to Lose You Money"



Source: Tullett Prebon Information, SEI

In Germany, the most "advanced" example of our Bizarro-World fixed-income markets, negative yields extend out to seven years. Imagine. Investors are lining up to buy bonds that will pay them a negative return if held to maturity over the next 7 years. *Me take 5! What a bargain!* In Exhibit 2, we compare Germany's yield curve against its U.S. counterpart. Investors in U.S. securities have yet to land on Bizarro World, but the gravitational pull exerted by Germany's yield curve configuration is being felt across the Atlantic. Even though the U.S. economy is in the midst of a modest expansion and appears in no real deflationary danger, benchmark Treasury two-year notes remain within 40 basis points of their historic lows and ten-year maturities are only 45 basis points from their all-time lows, as of quarter end.

Exhibit 2: Germany Throws a Yield Curve Ball

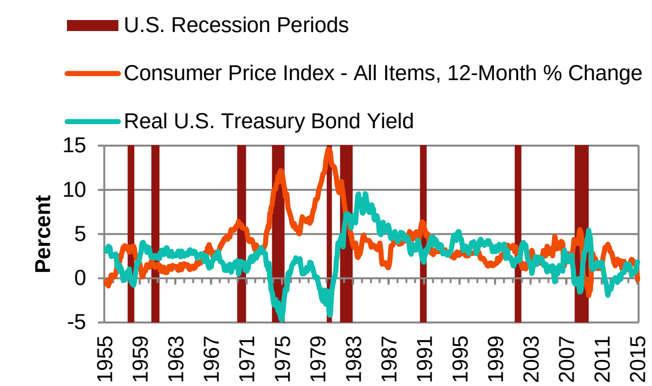


Source: Tullett Prebon Information, SEI

So what reasons can we give for this odd phenomenon of negative yields across countries and maturities in Europe? Low and negative inflation is one reasonable answer. Nominal yields have often yielded less than the rate of inflation, sometimes by a much larger margin than they do now. In Exhibit 3, we take a look at the relationship between 10-year U.S. Treasurys versus the one-year change in consumer price inflation. Note the two periods of highly negative real yields during the mid- and late 1970's. Those periods coincided with the two bouts of extremely high inflation caused in part by the soaring price of oil. The first oil shock occurred during the Arab oil embargo of 1973-74. Inflation peaked at 11.75% in early 1975. Although nominal bond yields moved higher, they peaked well below the inflation rate because investors anticipated a fading of the oil-price spike.

Unfortunately, inflation declined only grudgingly following the deep recession of 1973-75. When the Iranian revolution led to another major disruption in oil supplies, inflation again accelerated, reaching an even higher peak of 14.3% by June 1980. A devastating bear market in bonds coincided with this second bout of high and accelerating inflation. Real bond yields went from -4.2% in June 1980 to a positive 9.4% in July 1983—a yield swing of 13.6 percentage points -- as recession and an aggressively tight monetary policy broke the back of U.S. inflation. Investors were slow to appreciate the virulence of inflation in the 1970s, but they were even slower to respond to its ebbing, with the inflation-adjusted 10-year yield staying at relatively high levels until the mid-1990s.

Exhibit 3: Once Upon a Time, Negative Real Yields Meant Rampant Inflation

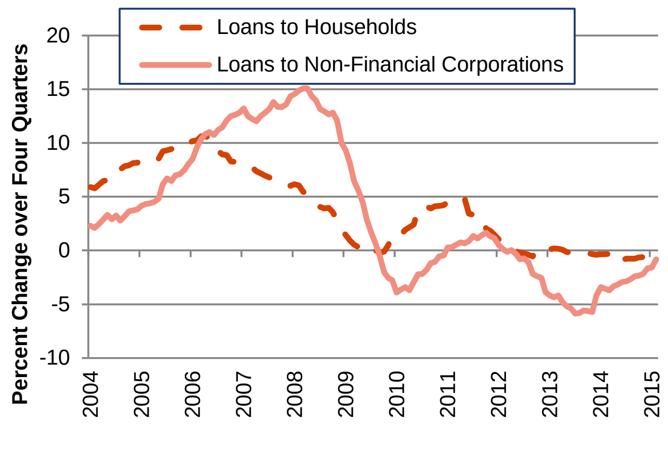


Source: Bureau of Labor Statistics, Economic Cycle Research Institute, Tullett Prebon Information, SEI

With the year-on-year change in consumer prices now negative in many countries, it therefore makes sense for nominal yields to be very low as well. However, we do not subscribe to the idea that global economic activity will remain so weak that price deflation will prove to be a sustained, multiyear phenomenon—even in problem-plagued Europe. We are doubtful that a European buyer of a negative-yielding two-year bond will earn a real profit holding the note to maturity. Oil would need to suffer a secondary price collapse to $20-$30 per barrel versus a current price for Brent crude of $55 for that to happen. Deflation fears also seem very much out of place at a time when European economy-watchers are becoming increasingly optimistic about the region's prospects.

In the absence of deflation, why else would an investor hold a nominal bond guaranteed to lose money? Perhaps, because they have little choice. In the aftermath of the financial crisis, banks and other financial institutions are required to hold more capital against loans. The median Tier 1 capital ratio for European banks, for example, has climbed from the mid-7% area in 2007 to 12.8% at the end of last year. Also, banks in Europe have been reluctant to make loans. Loans to households and non-financial businesses in Europe remain becalmed, as highlighted in Exhibit 4. Although recent loan officers' surveys suggest that the lending freeze has begun to thaw, there is no denying that banks have preferred to hold liquid assets or lend to their national governments, whose debt is risk-free for regulatory purposes, than make riskier loans to the private sector.

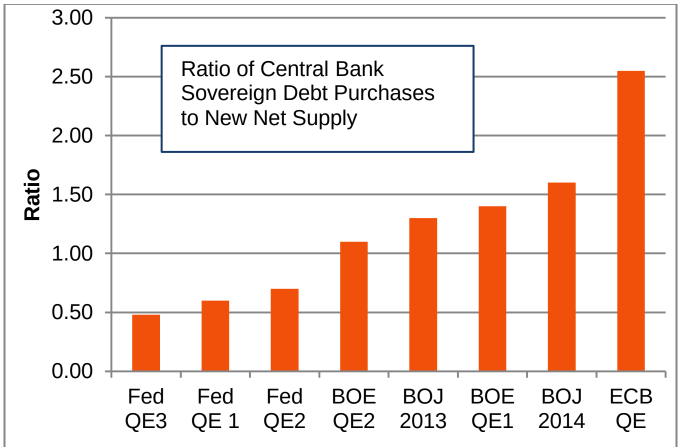
Exhibit 4: Looking for Thaw in Eurozone Credit



Source: European Central Bank, SEI

A third and, in our view the most important reason for an investor to buy a negative-yielding bond, is the expectation of selling the asset at a higher price. In other words, the Greater Fool Theory is at work here. And who is the greater fool? In this instance, it is the European Central Bank (ECB). As full-blown quantitative easing (QE) gets underway in Europe, ECB President Mario Draghi has been forthright in saying that the central bank is not a price-sensitive buyer. The ECB has announced its intention to buy negative-yielding securities as low as -0.2%, which happens to be the ECB's bank deposit rate. Presumably, the central bank could engineer additional reductions in the deposit rate if yields need to decline even further into negative territory in order to elicit an adequate supply of investable paper. According to GaveKal Research, the ECB's €45 billion per month of sovereign bond purchases through September 2016 amounts to 2.5 times the estimated net new supply of bonds that will be issued by eurozone governments over the next 18 months. The ECB's version of QE by this metric is a much bigger deal than the programs put in place by other central banks since the crisis, as highlighted in Exhibit 5.

Exhibit 5: Mario Wants Your Bonds

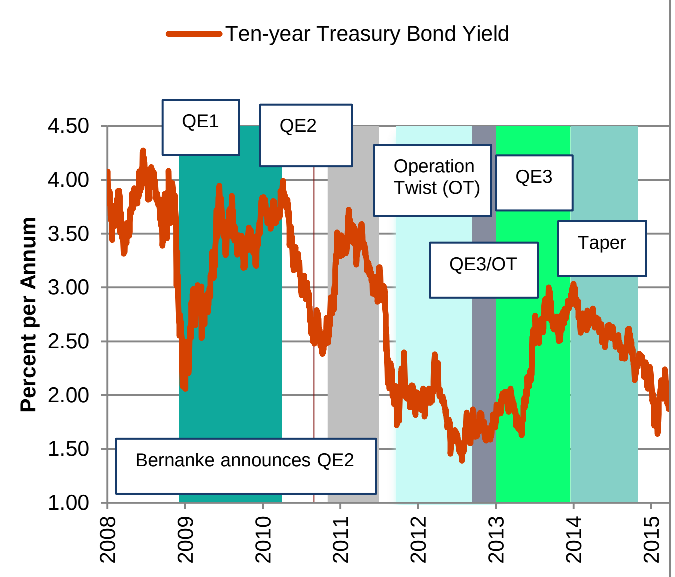


Source: GaveKal Dragonomics, SEI

It therefore seems like the perfect set-up for fixed-income investors: A price-insensitive buyer for securities that must bid aggressively to obtain paper because large financial institutions are reluctant to sell as a result of post-crisis financial reforms. Since there is no such thing as a zero bound anymore, the sky (or, should we say, a bottomless pit?) is the limit when it comes to European yields. All this is heady "this-time-it's-different" stuff.

We think it is worth recalling, though, the U.S. experience with QE. Exhibit 6 shows the various QE programs that had been put into place by the Fed from 2008 to the end of October 2014. As you can see, the yield on the Treasury benchmark bond frequently moved in unexpected ways. Instead of falling as one might intuit as the Fed purchased bonds, T-bond rates actually increased significantly during the implementation phase of QE1, QE2 and QE3. When those bond-buying programs drew to a close, yields tumbled. The main exception was Operation Twist, when the Fed was selling short-term bonds and buying long-term securities in an effort to manipulate the yield curve; there was no net increase in the Fed's buying of securities. We think this surprising behavior of T-bond yields before, during and after each QE episode reflected the risk-on, risk-off calculus of investors during the post-crisis period. When the Fed tried to wean the markets from QE, worries about the recovery's sustainability came back to the fore and investors returned to safe-haven assets. A return to QE, on the other hand, led to an increase in risk-taking and a preference for stocks over T-bonds.

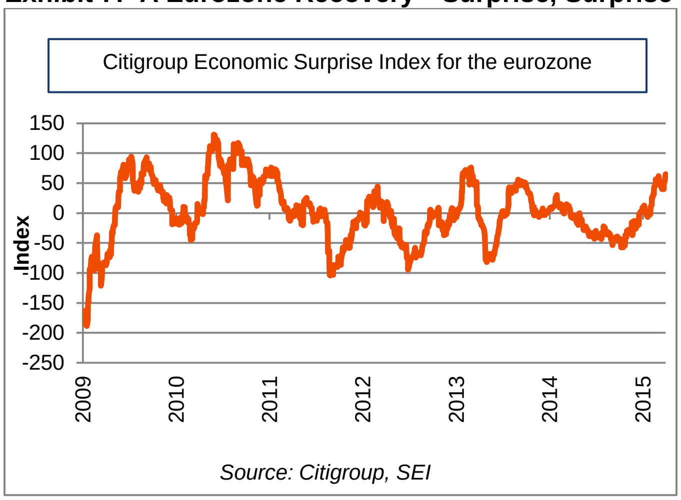
Exhibit 6: Yields Rose When the Fed Was Buying



Source: Barclay's, Federal Reserve Board, S&P, Ed Yardeni Research, SEI

Now that the European Central Bank is engaged in full-throated QE, there is a *bona fide* reason for economic optimism within the eurozone. Equity investors have responded, with the MSCI-EMU Total Return Index jumping 19% in local-currency terms in the year-to-date. To be sure, it is too soon to see much improvement in the economic data. But, unlike a year ago, when we were skeptical that the European economy was on the verge of a true recovery, we think the chances of one are much better now. The sharp depreciation of the trade-weighted euro over the past year and the collapse in oil prices are two extremely important events boosting the region's prospects. According to Citigroup, economic surprises have been strongly to the upside in the eurozone in recent months (Exhibit 7).

Exhibit 7: A Eurozone Recovery—Surprise, Surprise



Source: Citigroup, SEI

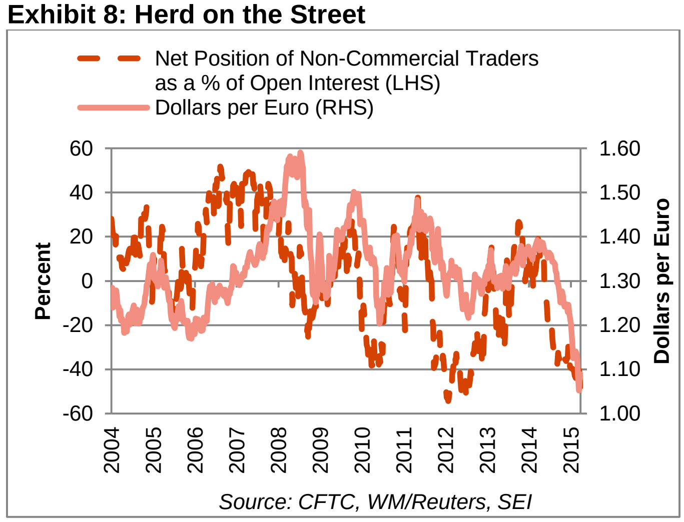
If the eurozone begins to enjoy a sustained recovery—even a relatively tepid one—we would expect deflation fears to diminish. In addition, investors' risk appetite in Europe should continue to improve, emboldened by the view that the European Central Bank will continue to pursue a monetary strategy that aims to support asset prices. Not only have equity prices soared in local currency terms, but sovereign and corporate bond yield spreads between the periphery and core countries of the eurozone have contracted meaningfully. Even the rising odds of a Greek exit from the currency bloc haven't had much affect. Obviously, European bond investors are not all that worried that a Greek exit from the eurozone will cause contagion. Or, perhaps, they think an exit will be delayed well into the future with yet another last-minute muddle-through bail-out.

In any event, we suspect that yields in Europe have a good chance of remaining at Bizarro-World levels in the months immediately ahead, given the aggressive QE program now being pursued by the European Central Bank. But we also believe that negative yields will prove an oddity in the annals of economic history in the longer run.

Euro Trashed

The odds favor further depreciation of the euro against the dollar as the monetary policies of the Fed and the ECB diverge. That expectation, however, is shared by the vast majority of investors and traders, if the positioning of currency speculators is any guide. Exhibit 8 tracks the net position of non-commercial traders in the euro as a percentage of open interest on the Chicago Mercantile Exchange. Net short positions are more extreme than they were in 2010 and almost as high as they were in 2012. On both occasions, the euro posted an important low. In 2010, the rebound coincided with the first Greek bailout, and in 2012 the European currency soared on the heels of Mario Draghi's "whatever it takes" remarks and the introduction of the (never-used) "bazooka" known as the Outright Monetary Transactions (OMT) program.

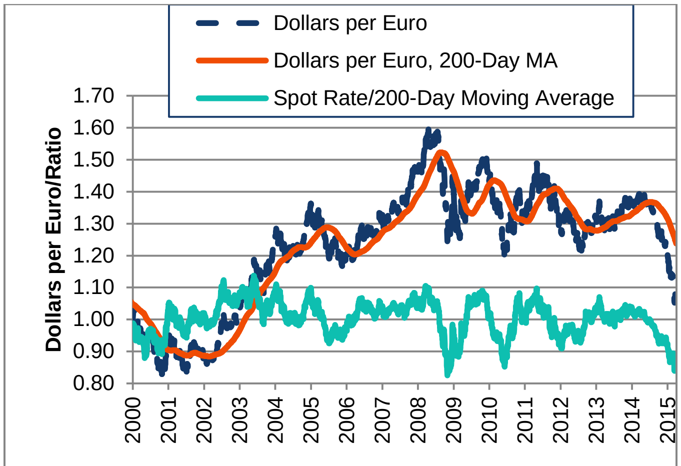
Exhibit 8: Herd on the Street



Source: CFTC, WM/Reuters, SEI

It is hard to dispute the view that shorting the euro is a very crowded trade. It is also clear that the euro's decline over the past year has been extraordinary in its magnitude. Exhibit 9 highlights the euro's value against the dollar measured against its 200-day moving average. The euro is now 13% below its 200-day moving average, an extreme that has only been reached twice in its 16-year history.

Exhibit 9: The Euro Sell-Off — Fast and Furious



Source: WM/Reuters, SEI

We understand the overwhelming bearishness toward the euro and extreme bullishness on the dollar generally. Everyone knows better than to fight the central banks. The ECB is increasing its balance sheet and driving down interest rates, while the Fed is taking its first tentative steps in the opposite direction. Why shouldn't the euro keep falling? We think it will, but over a longer time frame. In the near term, look for the euro to churn until some of the excessive positioning against the currency is squeezed out.

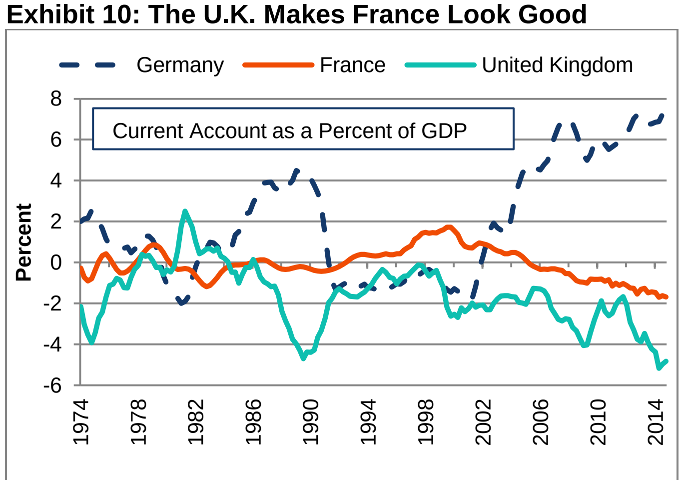
Signs of economic improvement in the eurozone, another last-minute agreement with Greece on a bail-out package, or intimations by the Fed that U.S. rates will stay lower for longer could spark sporadic, but sharp moves to the upside in the euro. We already witnessed one such episode following the release of the Federal Open Market Committee's (FOMC) statement on March 18. The euro started the day under 1.06. With the removal of the word "patience" from the Fed statement, the euro would have been expected to weaken against the dollar. The exact opposite occurred, driven by the dovish nature of the overall Fed statement and following comments in the press conference. As a result, the Euro shot through 1.07 upon release of the minutes and then soared from 1.084 to 1.104 within 10 minutes around 4 PM EDT. It then gave back almost all its post-FOMC statement gains the next day. Obviously, there was nothing fundamental about this trading. Indeed, it's extremely disconcerting that a market as deep and supposedly efficient as the one for trading dollars and euros could be subject to such breath-taking moves. But this volatility is one of the unintended consequences of monetary policy in Bizarro World.

(Dis)United Kingdom

Before we leave Europe, we should focus on developments in the U.K. The economy continues to perform relatively well, although the pace of growth is hardly spectacular. The trajectory has been similar to that of the United States, with inflation-adjusted gross domestic product (GDP) fluctuating between 2%-to-3%. Household consumption has grown steadily since the second half of 2011. Other areas of the economy have been more volatile. Government expenditures have been squeezed, although not as radically as in Europe or the U.S. More recently, fixed investment has registered a decline as the energy sector responds to the collapse in oil prices.

More worrisome is the trend in international trade. The current account balance has been deteriorating on a secular basis for the past 15 years (Exhibit 10). Following a cyclical recovery between 2009 and 2011, the U.K. competitive position has been in continuous decline. At 4.8% percent of GDP, the current account deficit is at its widest point since the aftermath of World War II. To be sure, a driving force of the recent worsening of the current account reflects the economic problems of continental Europe, the country's largest trading partner. U.K. merchandise exports to the European Union fell to a five-year low in January. Total exports, including services, have drifted lower since 2011.

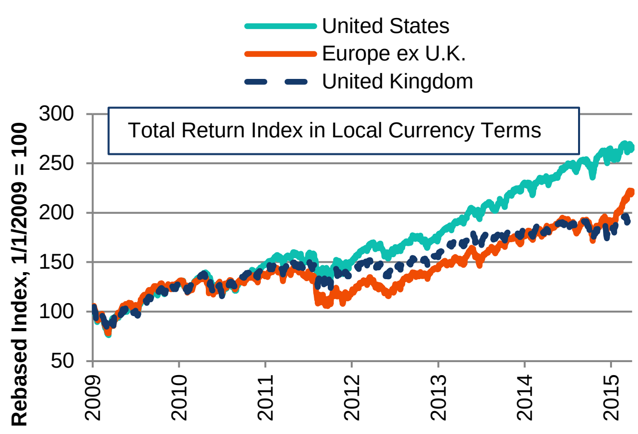
Exhibit 10: The U.K. Makes France Look Good



Source: OECD, SEI

With the MSCI—United Kingdom Index dominated by big multinational companies in energy, consumer staples, healthcare and financial services, it should not be surprising that the U.K. equity market has been a laggard against the U.S. and, more recently, the rest of developed Europe in local-currency terms (Exhibit 11). Although sterling has weakened somewhat against the dollar in the past year, it has appreciated sharply against the euro. So far, however, the Bank of England has avoided engaging in the currency wars, despite a headline inflation rate close to zero and a core rate that has eased to its lowest level (+1.7%) since 2009.

Exhibit 11: U.K. Equities Get Left Behind



Source: MSCI, SEI

Although there is a general expectation that the Bank of England will raise its policy rate from 0.5% soon after the U.S. Fed makes its own move, we have our doubts. With exports accounting for 28% of GDP, about the same as Italy and France and more than twice that of the U.S., the Bank of England (BOE) should not be in a hurry to raise interest rates. Boosting the pound even higher against the euro would only exacerbate the country's competitive disadvantage. Although we do not look for the BOE to join the 20 countries that already have cut their policy rates in the year-to-date, it's possible that the central bank will let sterling fall through benign neglect.

General elections will take place May 7, and the outcome is very much in doubt. Neither of the two main parties is expected to win an outright majority. If Labor wins, it would not be surprising if it were forced to the left of the political spectrum, teaming up with the Scottish National Party in a coalition government. Investors are likely to act negatively, and there is a danger of capital fleeing out of sterling assets and pushing the currency down. A Conservative victory, on the other hand, would require a move to the right toward the anti-immigrant, anti-EU United Kingdom Independent Party (UKIP).

Although investors might prefer the fiscal and economic policies of the Conservatives to those of Labor, the increased stature provided to UKIP under this scenario would raise the odds of a referendum vote in favor of a British exit from the European Union. That exit could potentially have a highly disruptive impact on U.K. trade and capital flows as well as the country's longer-term economic and political prospects. Investors will not wait around to see the 2017 dénouement of the EU membership referendum saga. Although currency markets already have priced in a severe bout of sterling volatility as the election draws near, the outcome could be even worse.

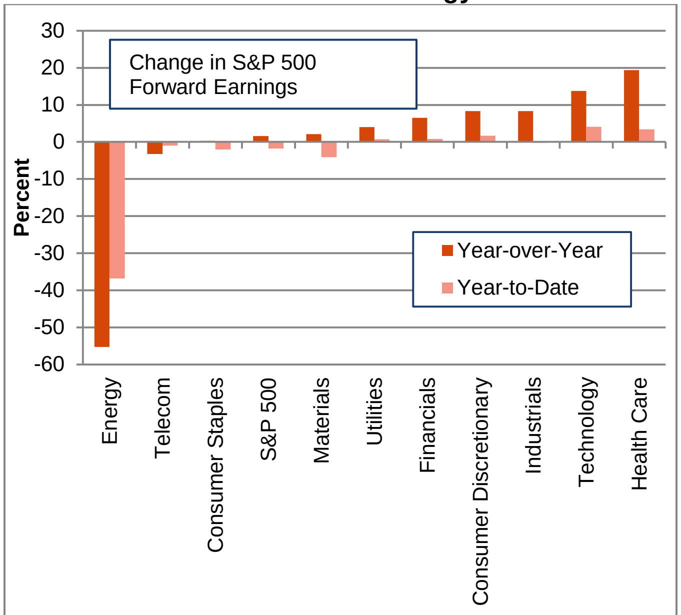
U.S. Economic Status: It's Complicated

Whereas the economic data in Europe have been surprising lately on the upside, they have been disappointing in the U.S. Some of this economic weakness (especially in retail, home buying and construction, and industrial production) has to do with the weather. In a fashion similar to last year's first quarter, business activity has been has been depressed by the severity of the winter. It's a good bet that better economic numbers will emerge with the crocuses. Still, hopes that inflation-adjusted GDP will finally breach the 3% barrier on a year-over-year basis may be dashed yet again as a result of the poor start in year to date.

Another impediment for the economy has been the collapse of oil prices. Automobile-centric America is still a net beneficiary of a drastically reduced price of crude, but the pain is immediate and concentrated in places like Texas, Oklahoma, Alaska and North Dakota. The price slide, for example, already has cut oil-rig activity nearly in half and initial unemployment claims in Texas have taken a jump. The oil bust also has dealt a stiff blow to the earnings of producers. The benefits of lower energy prices, meanwhile, are diffused across the country and are emerging with a lag.

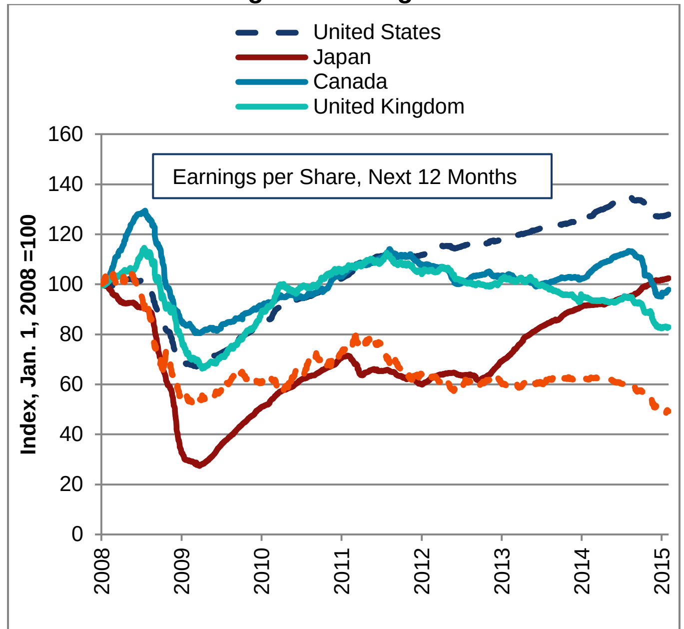
There's also the downside to the dollar's upside. The 19% rise in the trade-weighted value of the dollar over the past year has depressed commodity prices well beyond the oil patch. Exhibit 12 highlights the earnings-revision trend in the S&P 500 industry sectors in both the year-to-date and over the past 12 months. Not surprisingly, the energy sector is leading the decline, with forward earnings estimates falling more than 55% over the past year and almost 37% since the start of 2015. The projected earnings of materials companies also have come down sharply in recent months. Consumer staple stocks, meanwhile, is another sector facing an earnings decline, as the dollar's advance hurts the prospects of large multinationals.

Exhibit 12: Profits Run Out of Energy



Source: Standard & Poor's, Yardeni Research, SEI

Exhibit 13: Yearning for Earnings



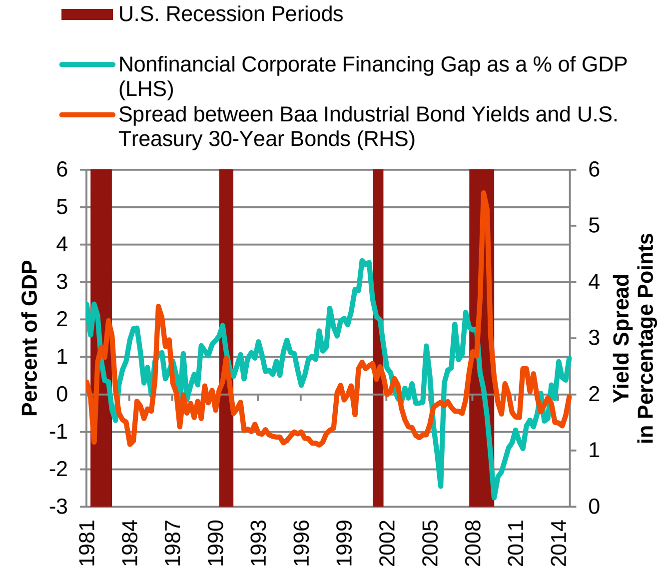
Source: MSCI, SEI

Analysts have been marking down their year-ahead earnings estimates since the autumn, with downgrades accelerating as oil prices began their plunge and the value of the dollar soared. However, as Exhibit 13 indicates, the decline in U.S. forward earnings has been less severe than those recorded in Canada, the United Kingdom and the eurozone. While economic and compositional differences come into play, we still are surprised that this is the case. We find the gloom among company analysts in the eurozone to be the most surprising. Earnings per share in the region recently hit a new cycle low despite the slide in the euro, the increasingly optimistic views of businesses and households, and the rebound in equity prices. Japan, in contrast, has been enjoying a strong upward trajectory in earnings since the yen started to weaken in late 2012. This may be one reason why Japanese equities have performed rather well this year, even in U.S.-dollar terms (despite the Bank of Japan's on-going quantitative easing program, the yen has been holding firm against the dollar).

It's hard to say with a great deal of confidence that the earnings trend is set to reaccelerate meaningfully in the U.S. The dollar and weak commodity price trends should remain a formidable headwind. On the other hand, we expect to see an improvement in consumer spending from the artificially depressed levels of the winter months. Homebuilding should also rebound, given the steady gains in employment and some easing in mortgage lending constraints.

We also note that the more challenging profits environment for U.S. companies has been accompanied by a notable deterioration in financial condition. The so-called financing gap, defined as the difference between capital expenditures and the internal funds generation of non-farm, non-financial corporations, has flipped in recent quarters, as shown in Exhibit 14. From 2009 until 2013, companies had generated massive amounts of cash flow versus their investment needs as a percentage of GDP (depicted in the chart as a negative number). Rather than invest those funds in plants and equipment, the excess cash was funneled away in foreign subsidiaries, used to buy back stock and pay dividends, or employed in mergers and acquisitions. In 2014, however, gross capital investment grew 11.5% while internally-generated cash showed little change.

Exhibit 14: Mind the (Financing) Gap



Source: Bureau of Economic Analysis, ECRI, Federal Reserve Board, Moody's, GaveKal, SEI

The re-emergence of a financing gap should not pose an immediate problem. Prior to the 2008 financial crisis, the non-farm non-financial corporate sector typically spent in excess of internal funds generation. With corporate bond yields as low they are, moreover, companies are willing borrowers. Still, when the next recession hits, a price likely will be paid in the form of a sharp deterioration in corporate credit spreads. Exhibit 14 shows that credit spreads tend to widen as the financing gap worsens, and as the economy nears the end of its expansion phase. We do not expect corporate bond spreads to blow out against Treasurys as they did in 2008. But it would not be at all unusual to see the yield spread widen by a percentage point or more if the financing gap increases further and recession nears. We emphasize again that the end of this expansion is probably still a few years away. Nonetheless, in terms of corporate financial health, the U.S. seems to have reached an inflection point.

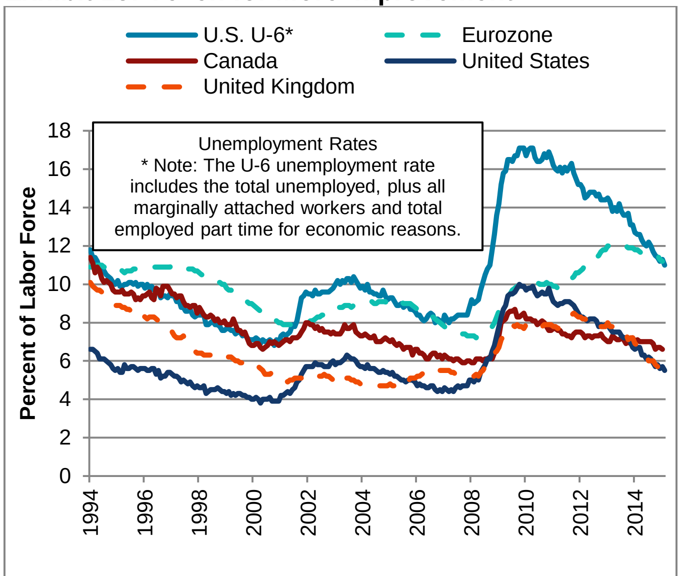
The Fed: From "Patient" to "Not Impatient"

The Federal Reserve's decision to remove the word "patient" from its policy statement raises the possibility of a Federal funds rate increase as early as June. In her press conference remarks, however, Fed Chair Janet Yellen emphasized that the Fed is "not impatient" to push through that first rate hike. The soggy performance of the economy in the recent months, the sharp rise of the dollar against most other currencies and little sign of near-term inflationary pressures justify caution when it comes to tightening monetary policy.

We understand the desire on the part of the Fed's policy makers to normalize rates, however. The near-zero interest-rate policy of recent years has created its own set of imbalances and anomalies. But most important for the conduct of monetary policy, the Fed would love to get some daylight between the Federal funds rate and zero before the onset of the next recession. The Fed would much prefer having the ability to fight the next recession in a more conventional fashion by lowering policy rates rather than resorting to quantitative easing from the very start.

Exhibit 15 underscores the improvement in the labor markets that has taken place. The official headline unemployment rate has fallen steadily from 10% in 2009 (which, at the time, was the same rate found in the eurozone) to a rate of 5.5% in February. Even the more inclusive unemployment rate, the so-called U-6 measure that includes workers marginally attached to the labor force and those working part-time for economic reasons, has recorded a notable improvement. After peaking in 2009 at 17.1%, the U-6 statistic has tumbled to a February reading of 11%—slightly better than the eurozone's current official rate. Although Yellen and Co. believe that the labor market can safely tighten further without generating an inflation problem, it seems an appropriate time to take away the punchbowl.

Exhibit 15: Yellen for More Improvement

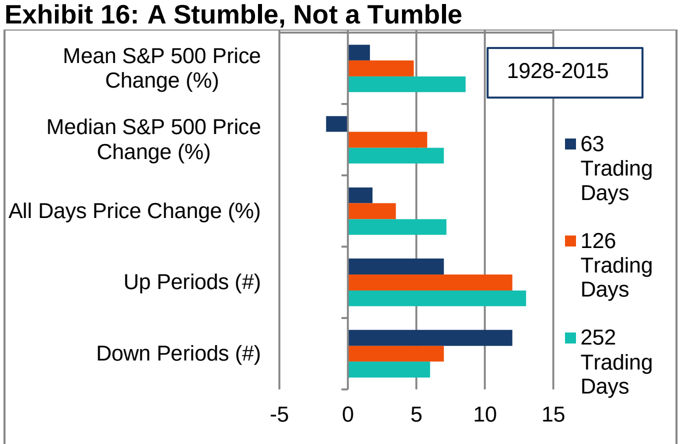


Source: Bureau of Labor Statistics (U.S.), Eurostat, Office for National Statistics (U.K.), Statistics Canada,SEI

The employment data notwithstanding, the policymakers at the Fed have tempered their expectations for growth and inflation. They also have cut their Federal funds rate forecast meaningfully from levels that had widely been regarded as unrealistically high. For year-end 2015, the median Fed funds rate forecast now is projected to be 0.625%, instead of 1.125%. By year-end 2016, the rate is expected to be 1.875% versus a previously estimated 2.5%. By 2017, the funds rate is pegged at 3.125%, for what it's worth. Traders in the futures market, however, continue to believe that the funds rate will stay lower for longer. At the end of 2015, 2016 and 2017, respectively, the market expects the funds rate to be around 0.45%, 1.25% and 1.75%.

Will the Fed actually begin to raise interest rates in June or September? Will we see one or two rate hikes before year-end—or none at all? Since Fed policy is "data dependent," the views of market participants (and Fed policymakers, for that matter) will shift with every surprising wiggle in the numbers. We should therefore expect an increase in financial-market volatility as we get closer to "lift-off." It's still our expectation, however, that the U.S. bull market is intact and any correction associated with the start of an interest-rate up-cycle will be limited. Exhibit 16 draws from a statistical analysis conducted by Ned Davis Research. It shows what has happened to equity prices three, six and twelve months after the first Federal Reserve policy-rate increase.

Exhibit 16: A Stumble, Not a Tumble



Source: Ned Davis Research, Standard & Poor's, SEI

Since 1928, there have been 19 occasions when the Fed initiated an interest rate up-cycle. The reaction during the first three months of a Fed-tightening sequence tends to be the most negative. In 12 of those 19 episodes, the S&P has declined; the median price change amounts to less than 2%. Six months and 12 months after the first rate hike, however, stock prices tend to be higher; indeed, the market has a tendency to perform at least as well, if not better, compared against all six- and 12-month periods in the historical record.

At least during the first year of a rising-rate regime, good news is good news. The Fed is raising rates because the economy is doing well. We realize that the current environment has its unique twists. Earnings multiples are already elevated, for example. Perhaps equities will prove more vulnerable to rising interest rates as a result. But we still think that a move in the federal funds from near-zero to 0.25% or 0.50% this year, followed by additional cautious adjustments in 2016, is not the stuff out of which equity bear markets are made.

Pulling the BRICS Apart

At the end of last year, we catalogued the headwinds facing emerging-market economies. A strong dollar was helping to pull down the price of commodities across the board. Sluggish economic conditions in China and around the world generally provided further reason for a cautious investment stance. Geopolitical tensions also had their impact, from Eastern Europe to the Middle East to Africa. Exhibit 17 shows that the MSCI-Emerging Market Total Return Index recently hit a new relative low against its developed-country MSCI-World counterpart, measured in U.S. dollars. The widening gap in price-to-earnings ratios between emerging and developed countries, also depicted in the chart, has yet to spark a turnaround in the asset class.

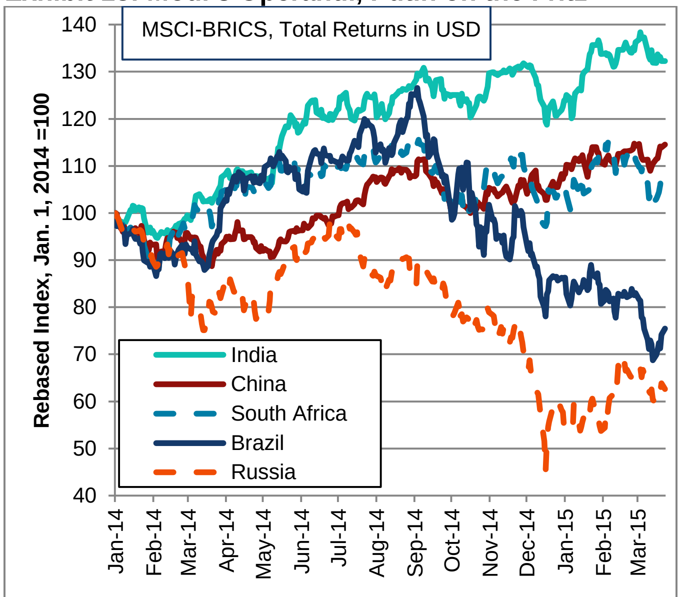
Exhibit 17: Emerging Market Equity: Cheap and Cheaper

Source: MSCI, SEI

It is not all bad news, however, as Exhibit 18 shows. Among the BRICS, India's stock market has enjoyed a total return in U.S. dollar terms of more than 30% since the start of 2014. China has recorded a gain of 17%, better than the performance of the MSCI-U.S. Index's cumulative 15% rise over the same period. Since the start of this year, Russia (+19%), India (+5%), China

(+8%) and South Africa (+3%) are all ahead of the U.S. market. Among the BRICs, only Brazil continues to lose significant ground, falling 15% in the year to date. Since the beginning of 2014, that country's equity market, as measured by MSCI, has suffered a 26% cumulative decline, a performance in dollar terms almost as bad as that recorded by the Russian stock market (-36%).

Exhibit 18: Modi's Operandi, Putin on the Fritz



Source: MSCI, SEI

Obviously, the differing political and economic fortunes of emerging markets make country selection a critical component of investment success in the current environment. Investors seem to be going with the flow when it comes to India, for example. Money has been moving into Indian stocks and bonds as investors continue to respond favorably to the initiatives of the Modi Administration. Although the task of reforming the Indian economy will be immense and subject to periodic setbacks, the Administration has enjoyed some initial successes. A little bit of luck doesn't hurt either. The collapse in energy prices has made it easier to cut subsidies, while generally lower inflation has permitted the Reserve Bank of India to cut its benchmark policy repo rate twice this year without weakening the rupee's value (the Indian rupee is one of the few currencies to rise against the U.S. dollar this year).

On the fiscal side, one of the government's bigger battles will be a reform of the tax system. The introduction of a uniform goods and services tax (GST) is aimed at replacing the patchwork of taxes imposed by the state governments that essentially serves as a barrier to interstate commerce. Another initiative involves increasing the share of central government revenues that is transferred to the states and letting them decide how best to use the funds.

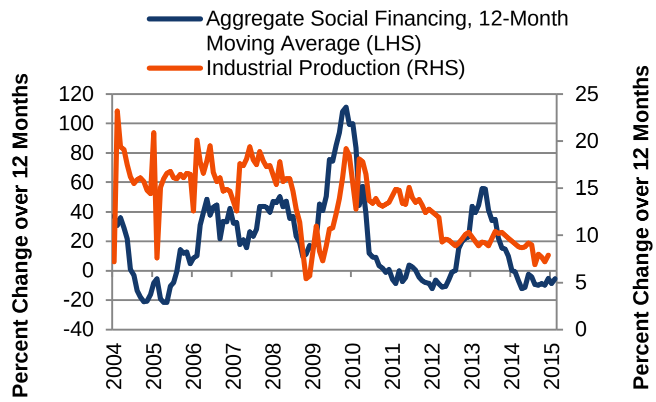
Of course, many other reforms will need to be put in place, whether it concerns liberalizing the ability of companies and government entities to acquire land for development, streamline regulations that stifle the creation of new businesses and the expansion of existing ones, or labor reforms that will make it easier to hire and fire. It is impossible to see how fast these reforms will be implemented and how successful they will be. But it can be said that the horrendous mismanagement of the Indian economy over the decades has left a lot of low-hanging fruit.

In sharp contrast, investors seem to be in full flight from Brazil. The real has crashed back down to levels against the dollar that have not been seen since the worst of the financial crisis in 2008. Inflation has been rising, reaching a 7.1% year-over-year rate; the Central Bank of Brazil has been forced to hike its policy rate to 12.75%, up two percentage points since the end of March 2014. Industrial production, meanwhile, fell 9.1% in the year ended February and GDP (through December 2014) has registered declines in three consecutive quarters on a year-over-year basis.

The country is as much a mess politically as it is economically. The Petrobras bribery scandal continues to widen, threatening President Dilma Rousseff's ability to govern the country. Although Rousseff's finance minister, Joaquim Levy, is well respected by the global investment community, the government's political weakness could stymie much-needed reforms. Investors understandably have adopted an extremely cautious view toward Brazilian reforms, in sharp contrast to their willingness to give the Modi government the benefit of the doubt when it comes to changing the direction of India's economy.

The Brazilian economy's struggles stem partially from the slowdown in China, to which 18% of its exports flow. The Chinese government has reduced its official GDP target to 7% from 7.5%, and we think it takes a statistical sleight-of-hand to reach even that growth rate nowadays. Yet, China has one of the better-performing stock markets, as we already noted. Although we have frequently expressed our concerns about the country's banking structure and the massive misallocation of resources, the government evidently has managed to maintain control over the economy's direction. In response to a declining inflation rate and a weak property sector, the government has been engaging in both fiscal and monetary stimulus in recent months. Aggregate social financing continues to ease, however, amid a further slowdown in industrial production to a pace of gain last seen in 2008-09, before the credit boom took hold (Exhibit 19).

Exhibit 19: A Chinese Squeeze



Source: National Bureau of Statistics (China), People's Bank of China, SEI

On the positive side of the ledger, China continues to introduce social and economic reforms that should lead to a shift away from its over-reliance on heavy industry and exports, to an economic model that depends more on consumption and the growth of services. In February, for example, the government announced the end of temporary residence permits (the *hukou* system). Migrant workers from the countryside needed these permits when they moved to urban areas, but they conveyed minimal rights to welfare services such as health and education benefits. The new system will allow migrants to access these services in their new place of residence without giving up their land rights in their home towns. It is unclear how quickly this new system will be expanded throughout the country, and the details for eligibility and funding have yet to be worked out. If successful, however, this program has the potential to accelerate the pace of urbanization and bring migrants "out of the shadows," allowing a fuller integration into urban consumer society.

In all, we agree with our emerging-market managers who argue that relative valuations in the asset class are compelling and that the long-term case for investing in emerging-market assets remains intact. However, the economic and political headwinds discussed above show that the group cannot be treated as a monolith. Opportunities for profit exist on a country, sector and company basis. We think a bottoms-up approach to emerging-market investing is the way

Strategy Positioning

Our equity investment managers appear to be generally constructive, although European equities hold comparatively greater promise in local currency terms. The U.S. still looks attractive due to expectations for growth and interest rate increases. Emerging markets—India and China in particular—are starting to show equity-market improvements. Fixed-income portfolios remain modestly short duration with a yield-curve flattening orientation. Portfolios across asset classes reflect a continued, although more moderate, expectation of U.S. dollar strength.

U.S. large-cap equity valuations have risen, due in part to a decline in energy company earnings. Low-beta stocks also appear expensive, so portfolio managers are letting cash levels rise rather than overpaying for defensive exposure. Positioning favors inflation and an eventual increase in interest rates, with an emphasis on momentum-oriented strategies. We expect large caps to continue outpacing small caps for the next several years until economic growth undergoes meaningful acceleration.

Global equity funds have a pro-cyclical orientation, with an emphasis on emerging markets and a preference for larger Asian economies. The situation in China has two sides: monetary policy tools are intended to support growth, but shadow banking and real estate troubles raise concern. Weakness in Brazil precludes a significant increase in investment, although Argentina is currently serving as a driver of Latin American frontier markets. Positioning in Europe has moved to a slight underweight (with managers taking off-benchmark positions in pursuit of alpha) as assets flow out of Germany and Switzerland. From a sector standpoint, portfolios are overweight technology, underweight financials and neutral-weight materials (having previously been underweight).

U.K. equities, in general, are fairly valued. While fundamentals are mixed, we expect earnings weakness to dissipate. Valuations are more attractive than in the U.S., and we expect that accommodative monetary policy will continue for longer than across the Atlantic. U.K. portfolio managers have a bias toward quality via fully-valued stocks. In Europe, stocks are no longer inexpensive, but a weak euro has supported exporters. Managers that are buying exporters are essentially shorting the euro. Managers generally remain pro-cyclical; from a sector standpoint, they are underweight materials, while miners and commodities are deeply out of favor. That noted, value-oriented managers see opportunity in oil-price weakness.

In core fixed-income, positioning for yield-curve flattening and a slightly shorter duration posture remain in place. We are modestly overweight corporate credit in spread-duration terms given their inexpensive-to-fair values. Industrials and utilities—last year's underperformers—are top-performing sectors today. We remain overweight non-agency mortgage-backed securities (MBS) due to attractive technicals and their persistent but eroding yield advantage. We are also positioned favorably to commercial MBS, generally among higher-credit quality issues. An abundant supply of municipal securities, partially attributable to seasonal effects, could create opportunity if they become cheap enough relative to U.S. Treasurys.

Fixed-income managers in the U.K. and Europe are now overweight the periphery. There is an interesting supply dynamic developing as a result of the ECB's purchasing more of certain issues than are being created. Diverging monetary and fiscal policies are leading to diverging country-level valuations. We were overweight European credit as spreads came in, and have rotated to U.S. credit. Brazilian bonds are beginning to look attractive as well. Selection is growing in significance as cross-section volatility in individual issues increases. From a currency perspective, managers are short the euro and sterling, as the latter is expected to suffer from election-induced volatility.

U.S. high-yield fixed income has seen a great deal of demand from non-U.S. investors seeking yield. There has been volatility centered in the energy sector due to oil-price weakness, although yield has come down from year end. Our largest underweight is basic industries—mining and metals—and energy is also underweight. We are overweight media on the basis of stability and relatively attractive yield. We remain overweight BBB rated credit, underweight BB and cautious of lower-quality credit. A preference for bank loans in the collateralized loan obligation (CLO) space continues as new issuance has settled and prices rose amid spread compression.

Emerging-market debt has continued to favor U.S. dollar-denominated issues as local debt declined on currency weakness. Local bonds offer higher yields, but are expensive when hedged, so we continue to underweight local issues. Managers have increased exposure to external debt. Mexico represents our largest country positioning, and we have a currency overweight in China and India. We are short duration, long yields and slightly lower-credit quality than the benchmark.

Within alternative strategies, we have seen opportunities in energy across relative value, distressed and merger/acquisition strategies. Structured credit remains constructive on residential and commercial MBS, and collateralized loan obligations, especially legacy issues. The event book represents one of our largest allocations as share buybacks, spinouts and activist investing lend support. Hedge-fund crowding represents a challenge as too much money seems to be chasing too few ideas.

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