Economic Outlook

Fourth Quarter 2015

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More of the Same in 2016…With a Little Less Certainty

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The late Gilda Radner's *Saturday Night Live* character, Roseanne Roseannadanna, should have been a market strategist. Reviewing the past year, we can't think of a better way of summing it all up than she would have: "It just goes to show you — it's always something!"

Economic and Policy

At the start of 2015, investors were working through the implications of the collapse of oil and other commodity prices. The European Central Bank's (ECB) implementation of quantitative easing then caused an already-weak euro to collapse versus the U.S. dollar during the first quarter. Meanwhile, the election of Alexis Tsipras in Greece and the anti-establishment Syriza party in January set in motion another round of high-stakes negotiations with Germany and the rest of the eurozone that threatened a Greek debt default and exit from the monetary union. Almost as soon at the Greek drama reached a more-or-less happy resolution (which technically turned the drama into a Greek comedy), the bubble in the Chinese stock market burst. In August, riskier assets across the globe fell again as Chinese authorities engineered a surprise devaluation of the renminbi (also called the yuan) against the U.S. dollar. The comforting thought that the Chinese government had the prowess to guide the country toward a soft landing was thoroughly shaken, leading to fears of a global recession.

In the U.S., there was endless speculation over when the Federal Reserve (Fed) would raise the federal funds rate and begin the process of interest-rate normalization. Surprising economic weakness in the first quarter pushed out the prospect of monetary policy tightening from early in the year to mid-year and then into autumn. The China-induced market volatility in August, however, caused the Federal Open Market Committee (FOMC) to back off from a September hike, leading to yet another round of market volatility. Fed Chair Janet Yellen and her colleagues subsequently changed their minds as the economic data improved, unanimously voting for the first increase in the funds rate since 2006 on December 16.

Still, in reviewing the course of economic decision-making around the globe, investors can be forgiven for wondering if any economic policy maker anywhere knows what they are doing.

Politics

Politics also provided a full helping of uncertainty that moved markets. The previously mentioned Greek election was the first big event. The U.K. general elections in May then created their fair share of uncertainty. Although the election outcome favoring Prime Minister David Cameron and his Conservative Party was benign for markets, it did lead to the ascension of Jeremy Corbyn as leader of the Labour Party. The next electoral hurdle for the U.K. lies ahead, with the referendum on exiting the European Union (EU) taking place as early as June, and no later than the end of 2017.

Elsewhere, Canada witnessed a change in regime, with power transferring from the Conservatives to the Liberal Party and Justin Trudeau. In the southern hemisphere, Brazilian President Dilma Rousseff ended a disastrous year with the possibility of impeachment charges. Partial regime change through the ballot box, meanwhile, occurred in Argentina with the election of Mauricio Macri as president, thereby ending 12 years of rule by Cristina Fernandez de Kirchner and her husband Nestor Kircher (both of the Peronist party) who preceded her. The Peronists still are a force to be reckoned with in the Congress, however. Governmental change was more thorough in Venezuela, where President Nicolas Maduro and his fellow Chavistas (left-wing supporters of former President Hugo Chavez) were routed in the parliamentary election to such an extent that Maduro could face a recall election in 2016. After packing the Supreme Court, the Maduro regime is seeking to deprive the opposition of its supermajority. The outcome of this gambit remains to be seen. At least there now exists the promise of better economic management and corporate governance in both Argentina and Venezuela; although turning around the economies of both countries would be extremely difficult in the best of times. The current environment of sharply depressed commodity prices and weak trade flows presents formidable hurdles.

Elections in Portugal resulted in the victory of a leftist coalition that is unfriendly to the concept of austerity imposed by the EU. Spain has also seen its political landscape transformed into a potentially unstable four-party system with the recent electoral success of the far-left Podemos party and the liberal-leaning, but market-friendly Ciudadanos party. It's too early to tell if economic reform efforts are in jeopardy, but the election results highlight voters' impatience with the status quo.

Although the incumbent center-right People's Party managed to gain the most votes, there is no easy way to cobble together a parliamentary majority. It will be just as difficult, however, for the opposition on the left to work together, given the radical nature of Podemos.

At the far right of the political spectrum in Europe, France saw Marine Le Pen's National Front party score significant gains in popularity (but no regional-wide ascension to power) in the wake of the tragic events in Paris. As religious extremism in the Middle East and North Africa goes from bad to worse, Europe finds itself in a humanitarian crisis and is experiencing the biggest refugee migration into Europe since World War II. Poland's far-right Law and Justice Party also scored an overwhelming parliamentary majority, playing on fears stimulated by the migration crisis. It is now pursuing populist economic policies that may well undo the economic and social reforms of the previous government; the country seems to be going down the same road as Hungary.

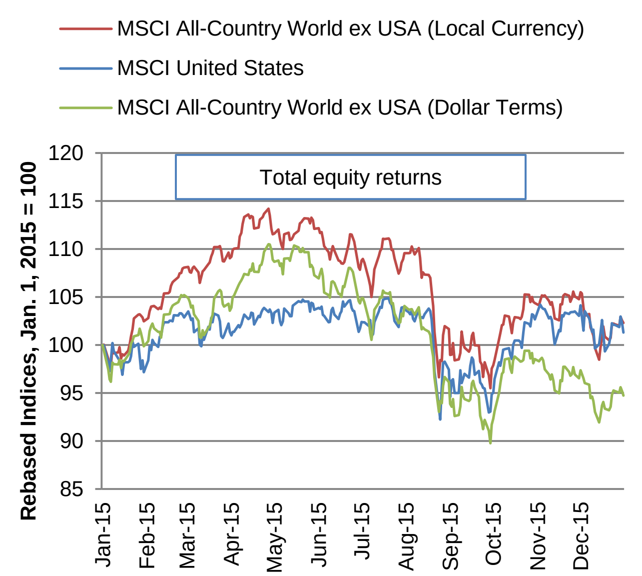
Terrorism

The terrorist attacks in Paris, Istanbul, Beirut, Sinai, London and San Bernardino in the past three months leave the impression that the world is becoming a more dangerous place — even in developed countries. This perception has strengthened the position of anti-establishment, anti-immigrant parties in Europe and has weakened the political standing of German Chancellor Angela Merkel, the most important political figure on the Continent. Impatience with the political class is not limited to Europe, however. The political landscape has been jumbled in the U.S. as well, with Donald Trump, Bernie Sanders and other candidates outside the mainstream enjoying unexpectedly strong popularity in what is turning out to be a U.S. presidential campaign that is even more bizarre than a *Saturday Night Live* skit.

The Result

Markets have generally reacted to this litany of bad news with a yawn. Obviously, there has been a great deal of volatility. The S&P 500 Index, for example, registered a correction during the third quarter (prices fell by 10% or more) in the first decline of this magnitude since 2011. Yet from January 1 to December 31, the S&P 500 Total-Return Index gained 1.4%. The MSCI All-Country World ex USA Total Return[1] Index outperformed the MSCI USA Index by just one percentage point in local-currency terms, but fell by 5.25 percentage points when converted into U.S. dollar terms, as shown in Exhibit 1.

Exhibit 1: Going Abroad Versus Staying Home



Source: MSCI, SEI

In the fixed-income market, the 10-year Treasury bond began the year at 2.17% and ended it at 2.30%, an increase of 13 basis points. On a total-return basis, the U.S. Treasury 10-year bond advanced just 0.9%. Even in the battered high-yield bond market, the total return is down only 0.91% when the energy sector is excluded. In short, the market outcome by year-end would be equivalent to the tagline of another Gilda Radner character from *Saturday Night Live*, Emily Litella: "Never mind."

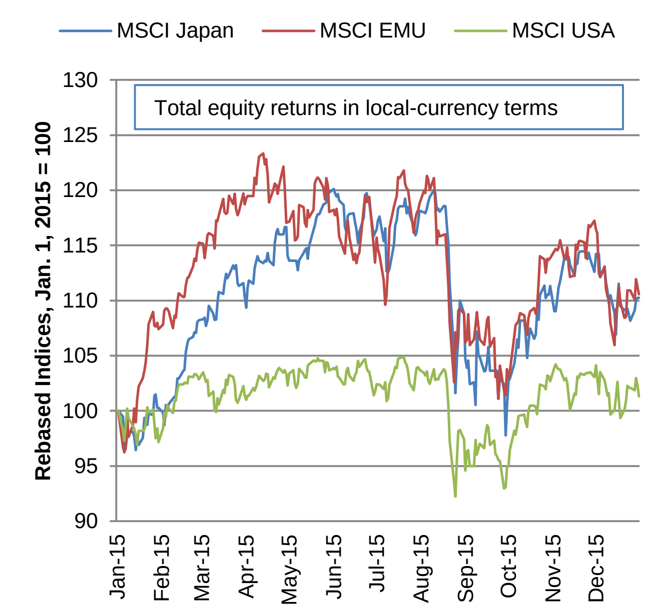
To be sure, not all financial markets finished close to where they started. Commodities, currencies and emerging-market debt and equity registered sharp declines in 2015. Surprisingly, long-dated German bunds fell by more than 10% in total-return terms despite quantitative easing, negative short-term interest rates and ongoing fears of deflation throughout Europe. Investment success last year depended on having little exposure to energy and other commodities, being long the U.S. dollar against most other currencies (at least through the first few months of the year) and emphasizing developed-economy stock and bond markets over their emerging-country counterparts. Reviewing our year-ago expectations, we were optimistic about developed equity markets and looked for high

[1] Total return indexes assume that cash distributions such as dividends are reinvested back into the index.

single- and low-double-digit equity returns. We expected significantly lower energy prices and more accommodative monetary and fiscal policies to boost economic growth and provide a tailwind to equity prices, especially in Japan and Europe. We thought the U.S. would post a moderately positive equity-market performance, but we also suggested that it would lag the gains of Japan and the eurozone on a local-currency basis. Both of the latter regions were expected to benefit from more-expansive monetary and fiscal policies and a subsequent move out of recession. Significantly, SEI favored the U.S. dollar over most other currencies at this time last year. We anticipated modest upward pressure in global bond yields as economic growth improved, but also forecast challenging commodity-market conditions within this strong-U.S. dollar environment.

These broad calls proved reasonably accurate, especially in the first few months of the year. Since the spring, however, it's been harder to discern a consistent trend in a variety of markets and asset classes. The U.S dollar, for example, has traded in a wide range against the euro; although the euro was still down by 10% since the end of 2014. By contrast, the Japanese yen has held surprisingly firm against the greenback. Our equity views were too optimistic. Nonetheless, in local-currency terms, the MSCI Japan and MSCI EMU (eurozone) stock Indexes have performed well relative to the U.S. since the end of 2014, with gains of more than 10% compared against a 1.3% increase for the MSCI USA Index (Exhibit 2). Emerging-market equities, on the other hand, have continued to weaken, victims of U.S. dollar strength, dramatic commodity weakness and a variety of country-specific economic and political woes.

Exhibit 2: Strong Start, Rocky Finish for Japanese and Eurozone Equities

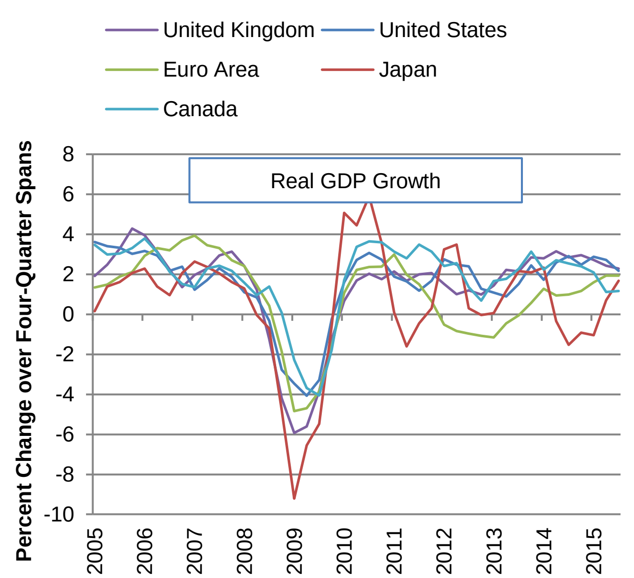


Source: MSCI, SEI

Global economic growth in 2015 was weaker than we expected. For example, we thought the U.S. economy would finally break out of its 1%-to-3% inflation-adjusted gross domestic product (GDP) growth straitjacket. It didn't happen. Personal consumption and residential fixed investment were solid, but household spending failed to accelerate in line with the sharp improvement in employment and after-tax incomes. Fixed business investment, meanwhile, was undermined by the recession in the oil patch. Net trade also suffered, as a strong domestic currency and sluggish economic conditions abroad resulted in a sharp acceleration in the volume of imports and an equally sharp deceleration in exports.

Europe, by contrast, recorded a modest improvement that was more-or-less in line with our expectations. Consumer demand picked up through the year and net exports advanced. But, outside of a few economic "success" stories, where GDP advanced by more than 3% (Ireland, Spain, Norway and several developing central/eastern European countries like Poland, Romania, Slovakia and Latvia), growth is still hard to come by, especially for the larger economies. Even the U.K., which has experienced one of the better recoveries from the Great Recession, saw its growth rate fall back toward the 2% area on a four-quarter span. As seen in Exhibit 3, inflation-adjusted GDP in both the U.S. and the U.K. has drifted lower in recent quarters, while the eurozone's overall performance improved slightly.

Exhibit 3: Another Year of Slogging Through



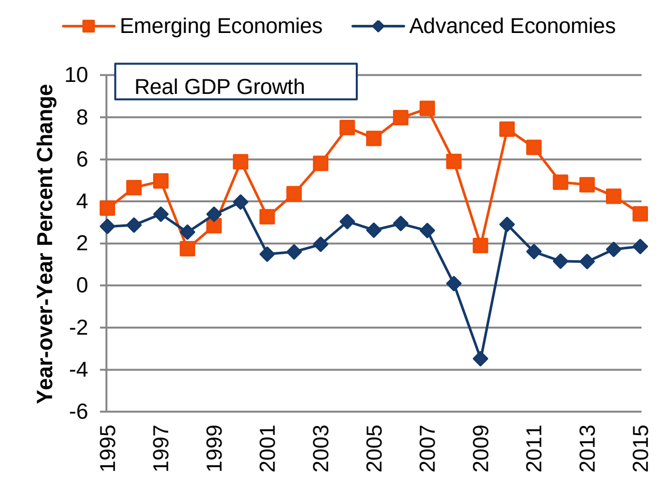
Source: FactSet, SEI

Of course, the biggest problems have been concentrated in commodity-producing countries. Among the advanced economies, Canada suffered a technical recession (two consecutive quarters of negative GDP) in the first half of 2015, driven by a sharp downturn in energy- and mining-related fixed investment. Australia's GDP has held up somewhat better than one might have expected, running near a 3% rate despite the crash in iron ore and other material prices due to the slowdown in China's industrial economy. With that noted, capital spending is in a prolonged multi-year decline, acting as a major drag on Australia's economic growth.

Among emerging economies, Latin America has been hit especially hard. Brazil's GDP contracted in six out of the last eight quarters through the third quarter. Venezuela is in even worse straits, owing to the oil-price collapse and destructive governmental policies that have led to shortages of a wide range of industrial and consumer products. Meanwhile, it's hard to say how bad things are in Argentina, given the questionable economic statistics. Perhaps the only positive sign is that the new government has come out of the gate with a bold currency reform effort that represents the first step in righting this particularly leaky ship.

Emerging Asia, meanwhile, also has seen its once-rapid growth fade in step with China's economic deceleration. Taiwan's real GDP, for example, fell in both the second and third quarters. Most other Asian countries continue to grow, but at rates that are well below the pace enjoyed prior to the financial crisis of 2008. Only India seems to be on a roll, with growth accelerating toward 10% on a year-over-year basis. As Exhibit 4 shows, the growth differential between emerging and advanced economies has rarely been as narrow during the past 15 years at it is currently.

Exhibit 4: Emerging Economies Losing Steam



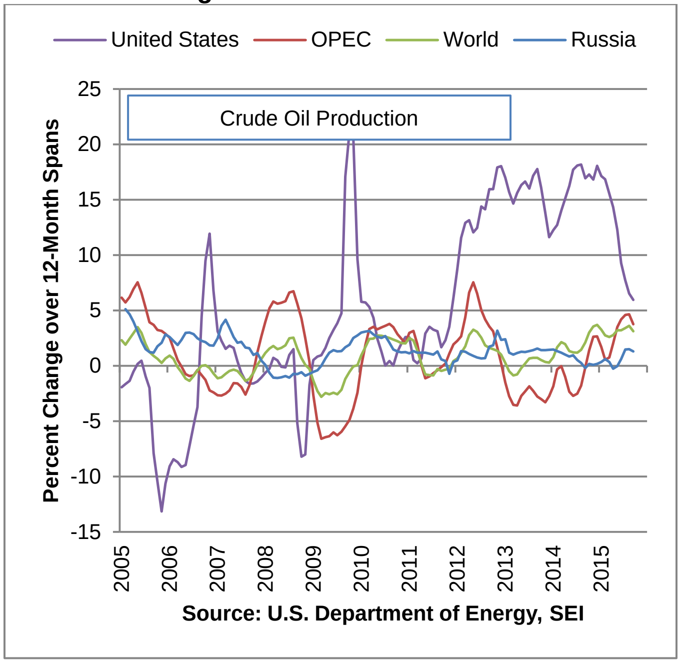
Source: SEI, Oxford Economics

Will Commodities Ever Recover?

The implosion in oil and other commodity prices has been a key driver of the global economy and financial markets in the past year. It has hurt emerging economies and financial markets. It is causing a major dislocation in the more speculative end of the high-yield market. It has also pushed inflation rates in developed countries to the point where central banks have been compelled to implement extraordinary measures, including quantitative easing and negative policy rates. Long-term bond yields continue to track at record or near-record lows in most countries. Last year, we thought the trend was getting so extreme that a major contrarian opportunity might develop at some point in 2015. While such an opportunity never materialized, there was a false start in the March-to-June period as West Texas Intermediate oil prices rebounded from nearly $43 per barrel to more than $60 per barrel. Other commodities also staged what turned out to be a temporary recovery.

The second half of the year proved devastating for commodities, however, as excess supply, global-growth concerns and pessimism over the outlook for China created a perfect storm. The slide in oil in recent weeks has been particularly unnerving. The outcome of the latest Organization of the Petroleum Exporting Countries (OPEC) meeting, of course, was the primary catalyst. Saudi Arabia continues to refuse to cut production and act in its traditional capacity as swing producer. In fact, the country's oil production has increased in the past year, as has output in Iraq, Iran and non-OPEC member Russia. In the coming year, Iran could post an additional significant rise in production when sanctions are lifted as part of last June's nuclear deal. Meanwhile U.S. oil production has stayed surprisingly resilient. Exhibit 5 highlights the continuing expansion of oil production. World production has advanced by 3.7% in the past year, its fastest gain in more than a decade despite the price decline.

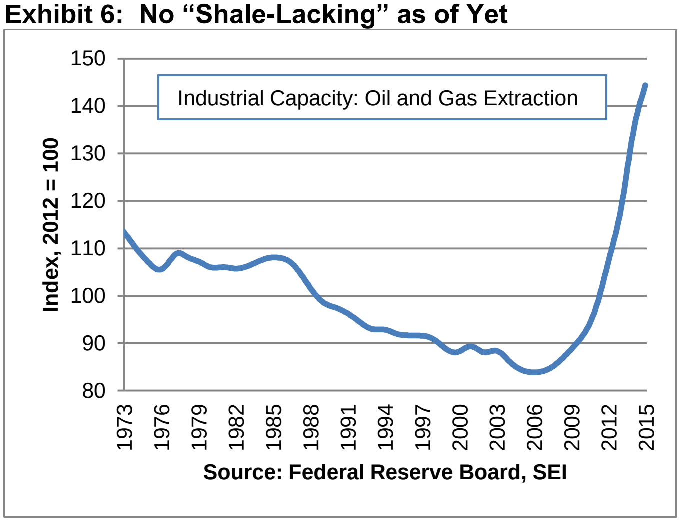
Exhibit 5: Rising Production Causes Prices to Slide



Source: U.S. Department of Energy, SEI

Our expectation that oil prices might settle in the $50-to-$70 range was far off the mark. A barrel of West Texas Intermediate has fallen much closer to the $30 level that marked the bottom of the 2008 price collapse. Although we correctly anticipated a sharp decline in the U.S. rig count, we figured there would be more of a supply response than actually occurred. As Exhibit 6 illustrates, however, a lot of capacity has been put in place since 2009, when the shale boom started. Although prices have fallen below the total cost of production for many companies, oil will continue to flow onto the market as long as revenues are generated at the margin to pay interest on debt. Until these companies are liquidated, the oil will likely flow.

Exhibit 6: No "Shale-Lacking" as of Yet

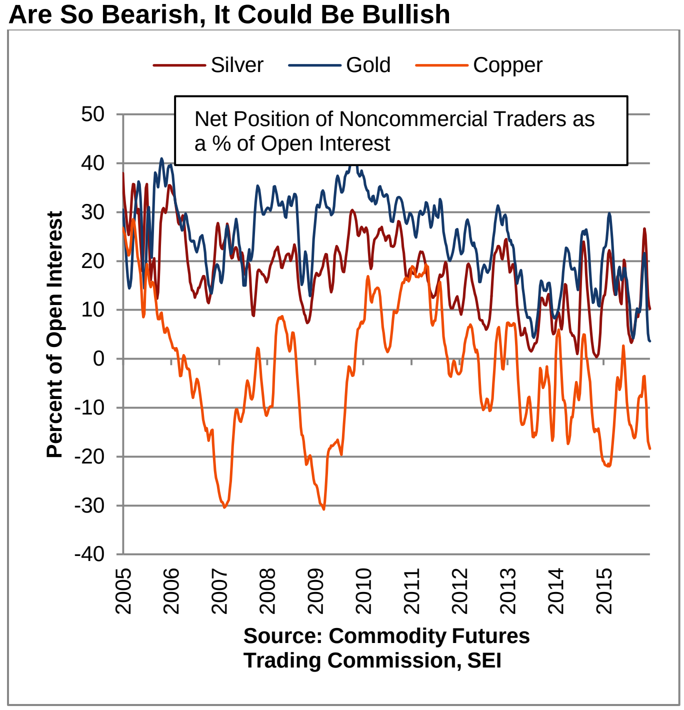


Source: Federal Reserve Board, SEI

The problems of over-production in the oil market are replicated elsewhere (copper, iron ore, gold, silver). Most companies might be unprofitable at these price levels, but that doesn't mean they will quickly shut down production. Although new investments are being put on hold, the process of equilibrating demand and supply is proving to be an arduous task.

It's hard to find a silver lining in this cloud. Nonetheless, we've been through enough cycles to realize that things look the most hopeless near the bottom. Accordingly, we think it's important to at least be aware that there are forces that could lead to a different, more bullish, result for the commodity markets in 2016. First, the sheer extent of price declines paves the way for meaningful counter-rallies similar to what occurred in the spring and early summer last year. Non-commercial futures traders are unusually bearish with regard to their positioning in the natural gas, heating oil, copper, gold, silver, soybean, corn and wheat markets. As with currencies, a large bullish or bearish net position among speculators does not imply that prices will inevitably go in the opposite direction. It simply highlights the fact that a trade is "crowded." If the outlook changes for whatever reason, prices could swing with surprising swiftness and magnitude as traders attempt to exit their positions at the same time.

Exhibit 7: Futures and Options Traders Are So Bearish, It Could Be Bullish



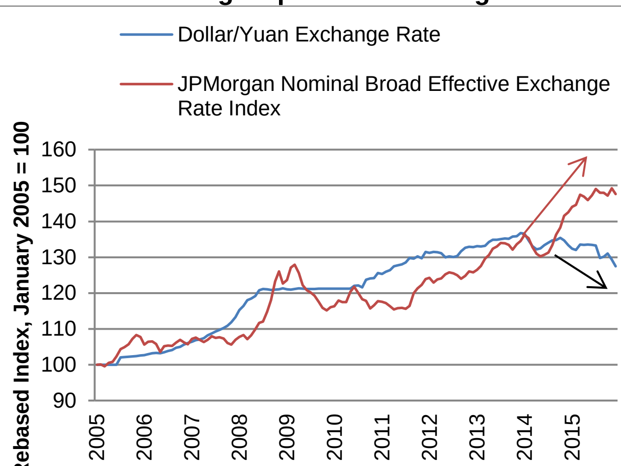
Source: Commodity Futures Trading Commission, SEI

Among the possible catalysts we think could lead to a better outcome: (1) signs of reacceleration in Chinese industrial growth; (2) stronger improvement in the big advanced economies (the U.S., Europe and Japan) than currently expected; (3) a truce within OPEC that leads to a change in Saudi strategy and a cut in crude-oil supply; (4) a quicker rationalization of high-cost production capacity than has occurred so far; (5) an unexpected weakening of the trade-weighted value of the U.S. dollar despite the beginning of an interest-rate up-cycle. None of these scenarios have terribly high probabilities attached to them, which is precisely why investor sentiment is so negative toward commodities, emerging markets and currencies other than the U.S. dollar. Increased exposure to these beaten down areas makes some sense, especially for those investors with a reasonably long time horizon — measured in years, not months.

Chinese Draggin'

As we noted above, economic developments in China have been key factors in the decline in commodity prices and the volatility in global financial markets. News that the country will manage the renminbi versus a currency basket instead of the U.S. dollar prompted another round of declines in global stock and bond markets in mid-December. The renminbi has fallen now below its August level against the greenback, when it first announced a loosening of the peg (Exhibit 8). In our third-quarter Economic Outlook ("China's New Export: Market Volatility"), we suggested that China would manage the currency to lower levels over time in order to regain lost competitiveness. The latest announcement seems to be another step down that road. Note, however, that the Chinese currency continues to rise on a trade-weighted basis, suggesting that monetary policy will need to get even more expansionary in order to push the currency in the desired direction.

Exhibit 8: A Yuaning Gap in the Exchange Rate

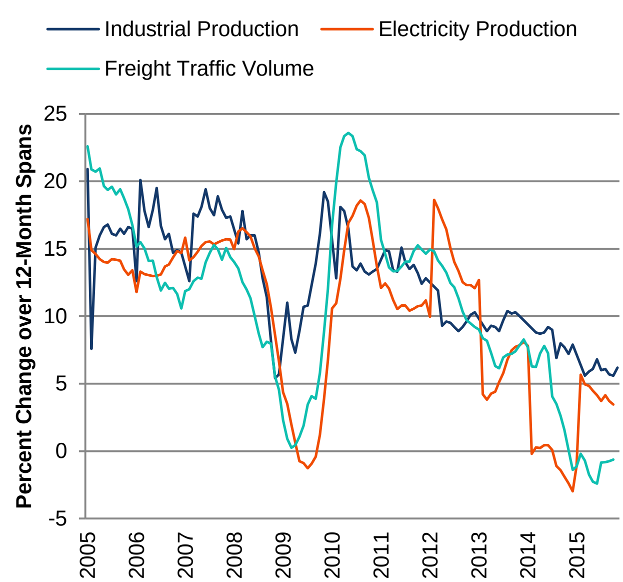


Source: JPMorgan Chase, WM/Reuters, FactSet, SEI

Investors obviously view this as another sign of the deepening economic gloom engulfing the country. We often have highlighted the country's massive debt burden, its misallocation of resources and the difficulty of transforming the economy from one that is heavily based on fixed investment and exports to one that is more consumption-based and services-oriented. There's no denying that the Chinese economy has been going through its most challenging period since the financial crisis. However, the more bearish the consensus view gets, the more reason to look for signs that some of these dispiriting economic trends might be changing.

At the very least, a case can be made that the slowdown in China is beginning to flatten out. Industrial production appears to be stabilizing at about a 6% year-over-year rate. Electricity output also seems to be finding a growth floor close to a 3% annual pace. While these indicators appear recession-like versus the 15%-to-18% annual gains recorded during the 2002-to-2007 expansion (Exhibit 9), at least we are seeing the emergence of stability. The deceleration phase appears close to an end, and even China's property markets are healing. Although construction remains depressed, owing to high inventory levels, home sales enjoyed a double-digit gain this year. Housing prices also are turning higher in an increasing number of cities.

Exhibit 9: China's Low Main Indicators



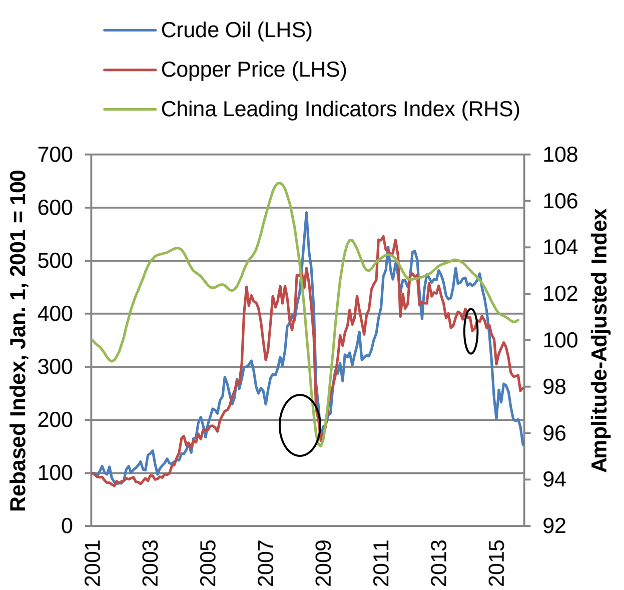
Source: National Bureau of Statistics of China, OECD - Main Economic Indicators, SEI

China may even be having some success in balancing its economy. Retail sales growth has been running close to 10%. Although this is a slower pace than prevailed earlier in the expansion, it is still robust compared to the manufacturing sector. Auto sales recently hit a new record high of 24 million units over the 12 months ended November. That represents a jump of 30% since the end of 2011.

The depreciation of the renminbi can be viewed as an important step in the process of easing monetary policy to stabilize the economy. The People's Bank of China (PBOC) has also been aggressive in employing its traditional monetary tools. Both interest rates and reserve requirements have fallen sharply in the past year. We expect PBOC policy to remain quite accommodative in view of low consumer-price inflation (1.5% year-over-year) and sharp year-over-year declines (-5.9%) at the producer level. While we expect further downward pressure on the renminbi, we also look for it to be a slow and deliberate process.

At this point, we would argue that investors have factored in the impact of a sluggish Chinese economy. Exhibit 10 highlights the country's leading economic indicator (LEI), versus oil and copper prices. Note that the LEI has inflected higher, well above the lows of 2008. Yet commodities themselves are trading at their 2008 lows and still show downward momentum. We think this is a discrepancy that bears watching.

Exhibit 10: Leading Indicators Have Stopped Declining, But Commodity Prices Have Not



Source: Commodity Research Bureau, London Metal Exchange, OECD, SEI

We see the weakening of the renminbi as a good news/bad news development. On the positive side of the ledger, it should improve the competitiveness of the industrial economy. It could lead to some easing of strains currently being felt by the manufacturing sector as a result of corporations' high debt and rising labor costs. However, it also shifts the pressure onto China's neighbors. We could see a round of competitive devaluations in the region in 2016. In addition, a substantial depreciation of the renminbi works at cross purposes against the Chinese government's longer-term goal of rebalancing the economy. Jump-starting economic growth is the more pressing issue, however.

If China can build on the tentative signs of recovery we are seeing, we believe it would be a net positive for those neighboring countries that export commodities and semi-finished manufactured goods. This would include Australia, Korea and Japan.

In particular, we maintain a positive stance toward the Japanese equity market for the following reasons: (1) weak energy and materials prices are a net positive for the country's consumers and businesses; (2) although the currency has appreciated in recent months on a trade-weighted basis, it remains at a far more competitive level than in 2012, before the advent of Abenomics; (3) corporate earnings are still trending upward; (4) stock valuations remain the most attractive of any major region; (5) Abenomics reform efforts continue apace and should get an additional tailwind as the recently concluded Trans-Pacific Partnership agreement is put into place over the next few years.

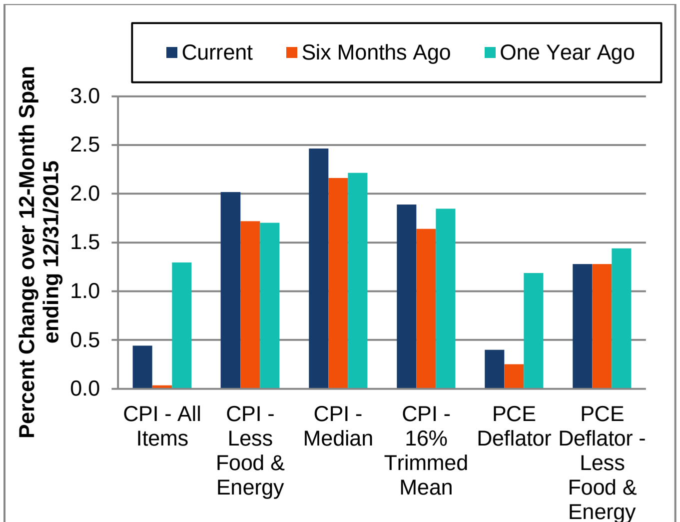
The U.S. Feels like 2011 Amid Fears of 2008

The much-anticipated "lift-off" move that raised the federal funds rate to a range between 0.25% and 0.50% is more akin to launching a hot-air balloon than a rocket. It's hard to believe the level of angst that even the decision-makers at the Fed felt six-and-a-half years into this recovery and expansion cycle. Bearish economic observers predict that the rate increase will need to be reversed before the year is out. That's a minority view. Market-implied expectations nonetheless remain more cautious with regard to the future path of the funds rate than the Fed governors' and regional Fed presidents' projections. The FOMC's median forecast (based on the so-called "dot plot") for the federal funds rate places it at 1.25% and 1.50% by the end of 2016 and between 2.25% and 2.50% at the end of 2017, with further increases in 2018 and beyond. By contrast, futures markets are pricing in just two increases in the funds rate over the next 12 months and another two in 2018.

Futures traders have been far more skeptical of quick interest-rate normalization (and more accurate in their projections) than the people who actually make the monetary decisions. Our base case for 2016 for U.S. interest rates is for more of the same. Now that the Fed has finally pulled the trigger, we expect yields to move slowly higher — much closer to the market's expectations than those expressed by the FOMC members in their dot-plot graph. The Fed will remain data-dependent, which means that it will be exceedingly careful in jumping to any conclusions about the economy's strength and its impact on inflation. In its statement following the December meeting, the FOMC said, it "will carefully monitor *actual* and expected progress toward its inflation goal."

This does not mean that inflation is non-existent. Core consumer-price inflation, excluding food and energy, has moved up toward 2%, with services leading way. Other, more esoteric measures of inflation, like the trimmed-mean consumer price index (CPI), which trims about 8% off each tail of the CPI monthly price-change distribution, also show prices rising at a pace closer to the Fed's target. The median CPI (the 1% of items that's exactly in the middle of the price-change distribution) has recorded a substantial rise in the past year of nearly 2.5%. But the inflation measure that carries the most weight in the Fed's rate-setting deliberations — the personal consumption expenditure deflator — remains quite sedate at 0.4% on an all-in basis, and amounts to just 1.3% when food and energy are excluded. As we predicted a year ago (and well before that) there will be no urgency to push through a series of hikes until inflationary pressures become more prominent.

Exhibit 11: Hawkish or Dovish, There's an Inflation Rate for You



Source: Federal Reserve System, U.S. Bureau of Economic Analysis, U.S. Labor Department, SEI

If the Fed pursues a cautious approach to interest-rate normalization, it should prove benign for global risk assets[2]. The first few hikes in the federal funds rate ordinarily are taken in stride by the equity market — and for good reason. The central bank will tighten policy only if there are signs that the economy is revving up its pace and placing significant upward pressure on prices and wages. Of course, rising price pressures normally mean that sales and profits are rising too — at least until monetary policy turns restrictive and provokes a recession. We are far away from that point. The Fed has no desire (and little reason) to lean hard against the economic expansion. As we have pointed out in other reports, investors tend to view good news as good during the first year of a rising-interest-rate regime. This is especially true in periods when the Fed treads cautiously.

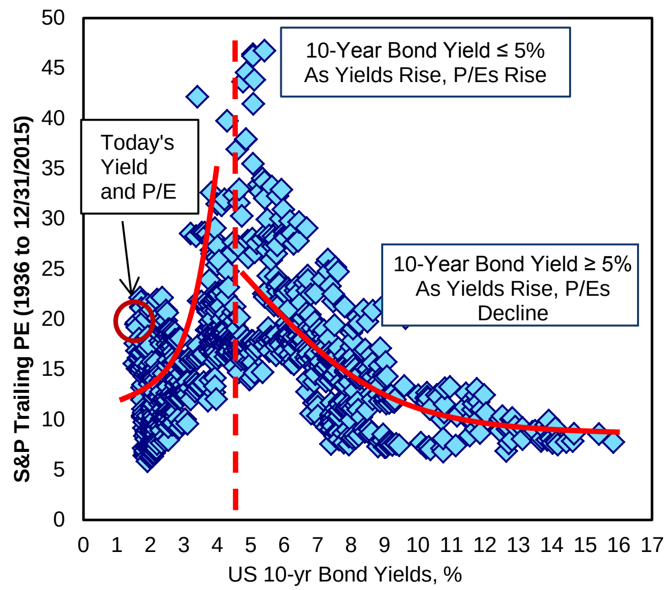
We concede that stock-market valuations remain problematic. The current forward multiple on the S&P 500 Index amounts to 16.4, still close to its high for this cycle and above the reading in mid-2007, just months before the onset of the bear market. While the multiples may be similar, the economic fundamentals are far different. Treasury bond yields, for example, were spiking above 5% in July 2007. Today, they remain stuck in a trading range at less than half that level. Oil was spiking on its way to a July 2008 peak of $140 per barrel. Most importantly, few imagined how rickety the financial system was at the time. The sub-prime crisis was just starting to hit the radar screen and the eye of the debt-debacle storm was still more than a year away.

Even if bond yields rise in sympathy with short rates, they would need to climb dramatically for stock prices to fall in significant fashion. Exhibit 12 compares the correlation between bonds and the trailing price-to-earnings ratio of the S&P 500 Index, as measured by Professor Robert Shiller of Yale University. 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 Treasury bonds.

When 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. We expect it will take a few years before bonds breach 4%, much less the danger zone of 5%.

[2] Risk assets carry a degree of risk, generally those with significant price volatility (equities, commodities, high-yield bonds, real estate and currencies).

Exhibit 12: Bond Yields Still Support Stock-Price Multiples



Source: RBC Capital Markets, Robert Shiller, SEI

In our view, the volatility of the past year and the very real pain felt in certain asset classes reminds us more of the 2011 experience than the calamitous tumult of 2008. If we are correct in that assessment, the proper course is to maintain exposure to risk assets and to continue buying (selectively) on the dips. We still like the odds of equities outperforming fixed income.

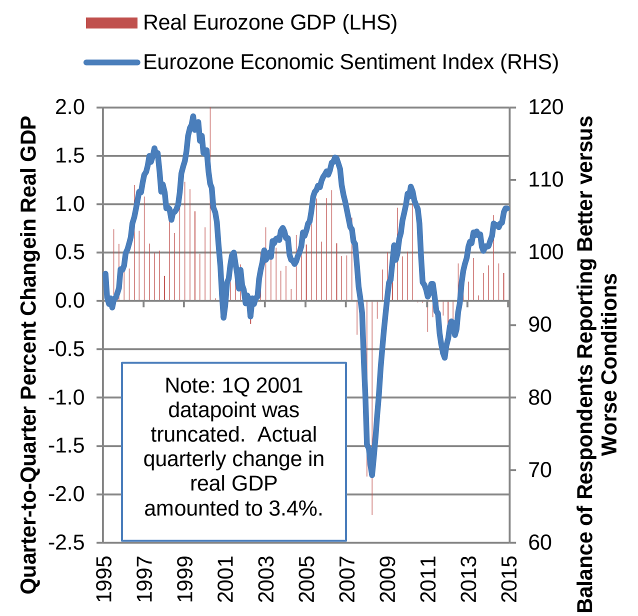
Draghi Disappoints

Although ECB President Mario Draghi is viewed as a rock star by many investors, he managed to severely disappoint them in early December. A tepid trio of moves (including a cut in the ECB's deposit rate that took it deeper into negative territory, an extension of the ECB's quantitative program to March 2017 and a pledge to reinvest interest and maturing paper) seemed meager fare after dovish commentary from Draghi and other policymakers prior to the decision. Stock markets fell, bond yields rose and the U.S. dollar depreciated sharply against the euro in the immediate aftermath of the decision.

While unfortunate, we view the whole episode as an example of poor messaging and expectations management on the part of the ECB. Draghi claims that the central bank stands ready to do more, if necessary. Of course, this will likely set up another wrestling match with the Germans and their austerity-minded allies, which the ECB president would rather avoid. It all comes down to how the eurozone economy does in the coming months. In U.S. Fed parlance, the ECB has become extremely data-dependent. At this point, the data seem to justify the doves' position in some areas but not in others.

Measures of business activity are improving. Exhibit 13 shows that economic sentiment has rebounded smartly, almost reaching the previous cycle's high. Although GDP growth remains subdued, the upward trend in sentiment suggests that actual growth should follow.

Exhibit 13: Europeans Feeling Better About Their Economy

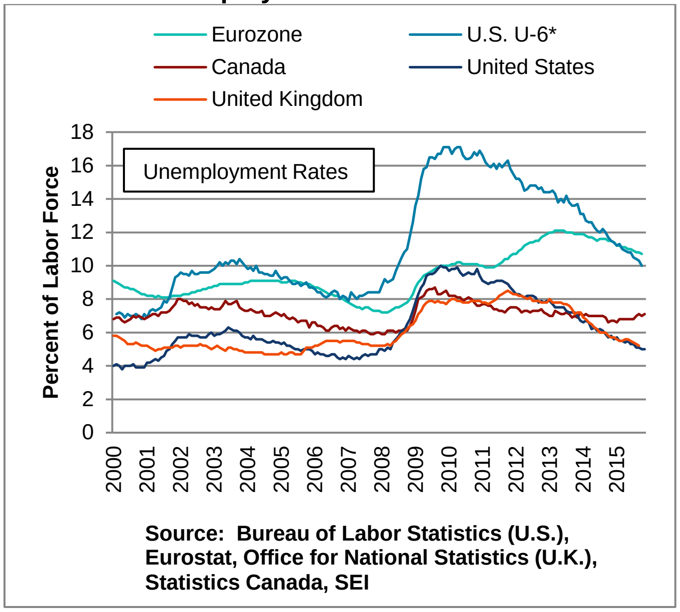


Source: European Commission, Eurostat, SEI

Purchasing manager surveys for several eurozone countries also have been fairly strong throughout the year. This applies to both manufacturing and services. Manufacturing output has climbed 2.2% over the past year. That performance handily exceeds the 1.2% decline logged by U.S. industrial companies, which have been hit hard by the recession in the oil and gas industry, a strong currency that has hurt competitiveness and unusually warm weather that has cut into the electricity output of utilities.

European consumers, meanwhile, have stepped up their purchases of goods and services to a 1.7% year-over-year rate of gain as of the third quarter. That may not sound all that impressive, but it is the best showing since September 2007. Even the unemployment rate has started to fall in meaningful fashion, although it is still more than twice the jobless rate in the U.S. The unemployment rate in the euro area also lags the progress made in the broad U-6 statistic that measures the unemployment rate of those in the U.S. who are working part-time for economic reasons and who claim to want a job but are not actively searching for one (Exhibit 14).

Exhibit 14: Unemployment Lines Get Shorter



**Note: The U-6 unemployment rate includes the total unemployed, plus all marginally attached workers and total employed part time for economic reasons.*

In short, Draghi has some grounds to claim that his policies are showing signs of success: monetary indicators also are recording their best growth in years. The broad money supply is expanding by a 5.1% annual rate, up from a cyclical low of 0.8% in April 2014. Lending to households and non-financial companies remains modest, but it is at least heading in the right direction. Consumer loans are up 1.9% over the 12 months ended November versus a 0.7% contraction at the cyclical low; business loans also have edged into positive territory (+0.8%), up meaningfully from the 3.8% rate of contraction recorded in November 2013. Just as important, corporate credit spreads between the periphery and core economies have narrowed, indicating that credit is starting to flow to areas that need it the most.

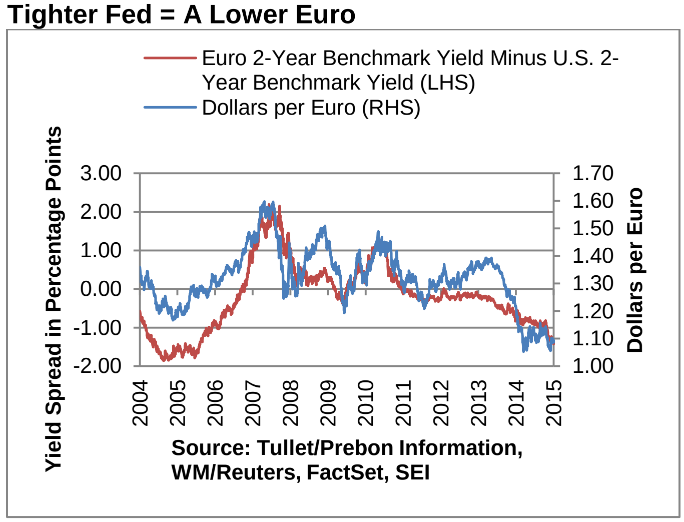
We expect further recovery in 2016 since the full impact of the ECB's monetary expansion is just starting to be felt. As the financial system continues to heal, the credit spigots should open a bit more. Adding to the mix is some loosening of the fiscal constraints that have hamstrung the weaker economies. Voters in several countries have become impatient with years of austerity; politicians are responding by running higher budget deficits. In addition, the migration of refugees from the Middle East and North Africa are forcing several countries, especially Germany, to add to their spending totals to meet this new humanitarian need.

In the third quarter, eurozone-wide government expenditures increased at a 2.4% seasonally adjusted annual rate, the sharpest gain since the first quarter of 2009. The rise in Germany's government spending was even steeper, totaling 5.1% at an annual rate.

The lagged impact of monetary easing and the big decline in the value of the euro against the U.S. dollar over the past 18 months should keep the eurozone economy on its expansionary track. However, we expect the ECB to do what it must to push inflation closer to its 2% target rate. We think this will entail a further expansion of the central bank's quantitative-easing program. Although our conviction level is not as high as it was this time last year, we still view an additional decline in the euro toward parity against the U.S. dollar as more likely than not. Europe's financial system is improving, but remains fragile. The odds of deflation, especially in a world of falling commodity prices, still seem rather high. The interest-rate gap between the U.S. and Europe continues to widen, as Exhibit 15 illustrates. We're betting that this widening gap will be an important driver putting additional downward pressure on the euro versus the U.S. dollar in 2016.

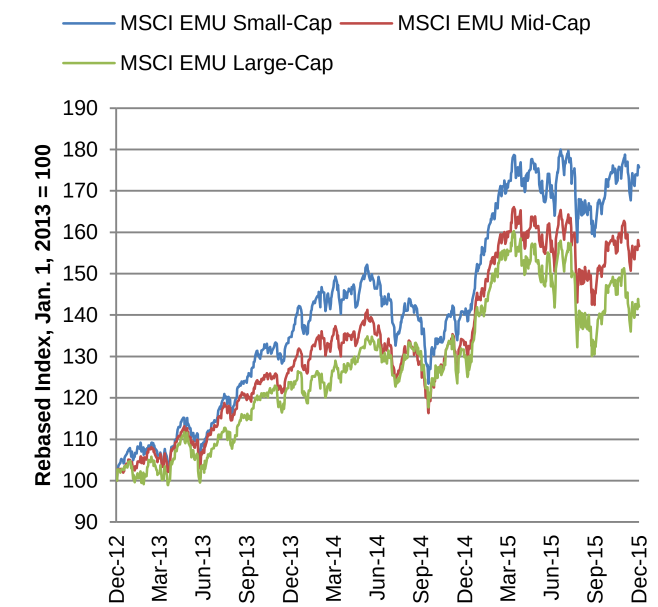
Although the economic performance gap with the U.S. has narrowed, the eurozone's equity performance was disappointing even in local-currency terms during the second half of 2015. This partially reflects the skepticism on the part of investors that the turnaround in Europe is for real. It also doesn't help that European equities tend to get sold off more sharply during periods of risk-off behavior. Finally, despite the big drop in the euro and the mild acceleration in economic growth, earnings still appear stuck in a rut.

Exhibit 15: An Easy ECB + A Tighter Fed = A Lower Euro



We understand that the European economy is structurally more rigid and less dynamic than the U.S., but this does not mean the region's stock markets are a poor investment on a shorter-term, cyclical basis. It is still our contention that the monetary union is slowly coming out of its long period of financial crisis and economic stagnation. In any event, small- and mid-cap stocks have performed much better than large companies in recent years. In the past year alone, small-company stocks rose by 25% while large stocks gained 9%; over the past three years, small-caps in the eurozone have delivered a 76% total return, far outpacing the 42% cumulative return in large-cap equity (Exhibit 16).

Exhibit 16: The Smaller, the Better



Source: MSCI, SEI

What's an Investor to Do?

The more things change, the more they stay the same. As investors enter 2016, they are facing as many uncertainties as last year — perhaps more. The widely held view that collapsing oil prices would prove a big positive for oil-consuming economies ended up being more wrong than right. On the other hand, fears of deflation and weak global growth failed to spark a big bull run in bonds. Risk-on/risk-off patterns alternated throughout the year, frustrating bears and bulls alike.

In some ways, the outlook seems more worrisome now than at the beginning of 2015. The damage in commodities, emerging-market debt and equity, and high-yield securities suggest a sharp deterioration in global economic fundamentals. Despite that, until central banks begin to pursue tighter money policies that raise interest rates to much higher levels and cause the yield curve to invert (short-term interest rates move above longer-term rates) we will give risk assets the benefit of the doubt. Although the U.S. has embarked upon a rising interest-rate phase, even Fed policy remains quite easy by the yardstick of previous cycles.

There is no denying that commodity-related assets and emerging markets have come under terrific stress. On the other hand, as risk rises and dispersion increases, the benefits of active management increase. In the section below, we relate how our managers are positioned across geographies and asset classes.

Strategy Positioning

Our equity investment managers maintain a pro-cyclical outlook, yet are mindful of headwinds such as rising interest rates, U.S. dollar strength, peak profit margins and low earnings growth. Fixed-income managers still seek to minimize the impact of commodity-related exposure (particularly in high yield), while emphasizing emerging-markets debt in Latin America and Africa and sharply increasing exposure to local-currency debt.

U.S. equity strategies generally remain oriented to market sensitivity, albeit with reduced exposure to momentum given expensive valuations. This exposure may start to increase, however, as the price of momentum has recently receded. Defensive and low-volatility premiums continued to moderate from earlier this year, no longer appearing so rich. Exposure to stability-oriented investments is being added to both large- and small-cap funds, owing to increased volatility and the aging expansion. Fourth-quarter earnings for domestically oriented companies were strong, with the exception of deep cyclicals such as energy and commodities. Any turnaround here next year could be a boost for overall earnings growth.

Global equity strategies favor value at the expense of momentum, which is crowded, mildly expensive and entering an unfavorable seasonal pattern. We are also underweight stability and low volatility. In terms of sectors, we are overweight industrials and information technology at the expense of consumer staples. Regionally, we have a small overweight to emerging Europe with a value tilt, and a small underweight to Switzerland and Germany. In terms of capitalization, we are overweight small caps.

Core fixed income maintained its neutral-to-slightly short duration[3] posture. We retain a yield-curve flattening bias via an underweight to the 1-to-7 year segment and an overweight to the 30-year. We are modestly overweight corporate exposure in risk terms; we are underweight

[3] Duration is a measure of risk in bond investing and indicates how price-sensitive a bond is to changes in interest rates. A long duration stance indicates the portfolio duration is higher than that of the benchmark whereas a short duration stance indicates a lower duration.

industrials (although adding selectively), neutral utilities and overweight financials. We are also slightly overweight to energy, primarily in the integrated and refining names, while underweight oil field service and midstream names. Managers are looking to add to names in the new-issuance market. We remain underweight agency mortgage-backed securities (MBS), but maintain off-benchmark allocations to non-agency mortgages, which continue to be a bastion of stability amid increased volatility. An overweight to commercial MBS remains despite an increase in supply combined with regulatory pressure from Dodd-Frank, which created an imbalance.

The high-yield market saw negative total returns during six months of the year — the worst results outside of a recession. We expect the current malaise to spread further in 2016 despite an improving economy. Our macroeconomic-level positioning continues to overweight CCC, as we believe many companies are incorrectly rated. In sector terms, we remain underweight to basic industries and energy, and favor media and retailers.

Our emerging-market debt managers are overweight high-yield in Latin America and Africa, and deeply underweight external debt with a relatively steady allocation to emerging-market corporates. A steep underweight to local-currency debt has been reduced sharply, while the largest currency overweights are in countries that stand to benefit from the decline in commodity prices (India) or those tied to the U.S. economic recovery (Mexico). The biggest currency underweights are in low-yielding Asian currencies (Thai baht, Malaysian ringgit).

Index Definitions

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

MSCI All Country World ex US Index: The MSCI All Country World ex US Index includes both developed and emerging-market countries, excluding the U.S.

MSCI EMU Index: The MSCI EMU Index (European Economic and Monetary Union) captures large- and mid-cap representation across the developed markets countries in the EMU.

MSCI Japan Index: The MSCI Japan Index is a broad-based index that tracks Japanese stocks.

MSCI USA Index: The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the U.S. market. It covers approximately 85% of the free float-adjusted market capitalization in the U.S.

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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. 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.

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

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