Economic Outlook

Second Quarter 2015

SEI New ways. New answers.®

Reaping the Whirlwind

By: James R. Solloway, CFA, Managing Director and Senior Portfolio Manager

SEI recently released its second-quarter 2015 Economic Outlook. A summary of its conclusions is provided below:

- Investors were caught up in a whirlwind, which included both volatility and surprising countertrend movements — ranging from German bunds to Chinese equities, currencies to the price of oil. The 10-year benchmark German bund yield has surged since mid-April, dragging yields elsewhere higher in its wake. The ferocity of the rise highlights how quickly supposedly deep markets can turn illiquid, even in the absence of severe economic stress.
- The relative resiliency of eurozone equities in the face of the bond-market decline has a simple explanation: The regional economy is starting to improve, albeit in a slow and halting fashion. Eurozone exports within the currency zone have climbed more than exports outside the currency zone — a sign that internal demand is picking up.
- Greece remains the biggest headwind that could blow the European recovery off course.
- The stunning victory of the Conservative Party in the U.K.'s May general election makes it a certainty that a referendum on the country's membership in the European Union will be held within the next 30 months. Opinion polls suggest that a majority of U.K. citizens are in favor of maintaining the status quo, but nothing should be ruled out.
- We think recent data may be overstating the extent of U.S. weakness. First, both employment and average weekly earnings are on the rise. Second, net worth has increased — thanks to the recovery in home values and the bull market in financial assets. Third, households now are in a position to take on more debt.
- In a mild-to-moderate growth scenario, U.S. corporate profits and cash flow should grind their way higher. Companies are finding ways to overcome the headwinds of a sluggish economy and weak top-line growth. This ability to manage costs during a challenging quarter far exceeded expectations at the start of the latest earnings reporting season.
- Market reaction to the Fed's June policy statement was a bit counterintuitive. The FOMC did not change consensus that the first rate hike could come in September, but equity prices pushed higher, bond yields fell and the dollar weakened to five-month lows. The large divergence between what the FOMC is projecting and what futures traders are expecting suggests that financial markets are vulnerable to a significant rise in volatility.
- The performance of mainland Chinese stocks was a big surprise. Although the markets in China became more turbulent toward the end of June, dropping more than 20% in less than two weeks, we cannot rule out a turnaround.
- China appears to be on a roll, but we feel compelled to point out how economies and financial markets can take unexpected twists and turns. We still believe that the trend in commodity prices is the best real-time barometer of China's economic health. Oil and other commodity prices are still quite depressed.
- Japan's economy seems to be coming back to life. Prime Minister Shinzo Abe has experienced some success in cajoling businesses to raise salaries. Still, Japan's central-government debt ratio is among the highest in the world and its population is among the oldest. Policy mistakes are magnified in a becalmed and deflation-prone economy.
- Our equity investment managers generally remain pro-cyclical; momentum appears expensive in the U.S, but competitively valued overseas. Larger Asian economies look favorable, while energy-sector reverberations continue to be responsible for many global pressures and opportunities. Investors in emerging markets will need to continue playing country-, sector- and company-specific opportunities, as opposed to riding a general wave of prosperity and growth. Fixed-income managers have noted liquidity concerns that are largely unrealized. Duration is modestly short, and the U.S dollar's ascent is expected to continue.

A full-length paper is available if you wish to learn more about this timely topic.

© 2015 SEI

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice. This information is for educational purposes only.

There are risks involved with investing, including loss of principal. Current and future portfolio holdings are subject to risks as well. Diversification may not protect against market risk. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Narrowly focused investments and smaller companies typically exhibit higher volatility. Bonds and bond funds will decrease in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments.

Information provided by SEI Investments Management Corporation, a wholly owned subsidiary of SEI Investments Company. Neither SEI nor its subsidiaries are affiliated with your financial advisor.

© 2015 SEI