Economic Outlook

Second Quarter 2015

SEI New ways. New answers.®

Reaping the Whirlwind

- In recent years, regional economies have diverged in significant ways. The U.S., the United Kingdom and Canada have experienced the best recoveries, while the eurozone, Japan and many emerging economies have lagged.
- This divergence in economic cycles has led to differing policy responses. The better-performing economies, led by the U.S., are on the cusp of monetary policy tightening, while Europe and Japan are expected to maintain their easing programs well into 2016. Most other central banks (both developed and emerging) also are expected to keep interest rates at unusually low levels for the foreseeable future.
- In this environment, we expect the global economy to gain traction, which should provide a tailwind to equity markets, even in those countries further along in their business cycles and facing rising interest-rates. Bond yields should slowly begin to rise as economic growth revives, global economic slack should keep inflation rates and bond yields near historically low levels.

The infernal hurricane that never rests
Hurtles the spirits onward in its rapine;
Whirling them round…
Dante's Inferno, Canto V,
Divina Commedia,
as translated by Henry Wadsworth Longfellow

The hapless lovers chronicled in Dante Alighieri's epic poem, *Divine Comedy*, are tormented in the Second Circle of Hell—forever caught up in a shrieking whirlwind that matches the carnal passions they shared while on Earth.

Although the passions in question here are not of the carnal variety, Dante comes to mind as we examine some developments that transpired within global financial markets during the second quarter.

Investors were certainly 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.

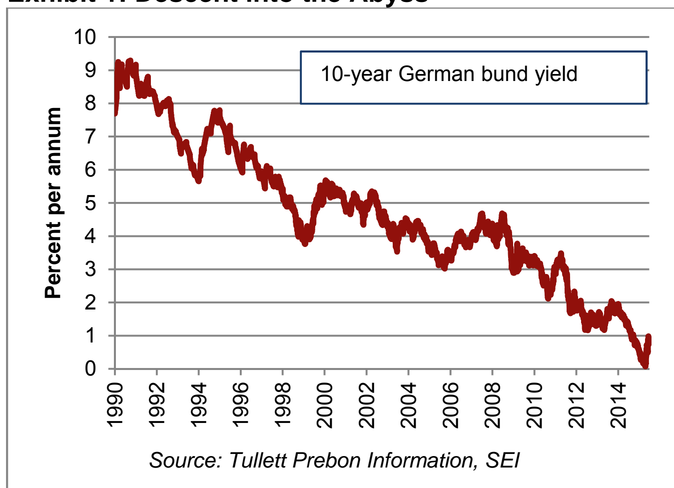
Europe was the focus of much of the attention. In last quarter's Economic Outlook (*Bonds in Bizarro World*), we highlighted the extraordinary fact that a large chunk of European sovereign debt was trading with a negative yield to maturity. At one point in April, the yield curve in Germany was negative out to a maturity of nine years. The yield on the country's 10-year benchmark bond dipped to a low of only five basis points (0.05%). As we noted at the time, the Greater Fool Theory seemed to be in effect: Investors assumed that the European Central Bank's (ECB) quantitative-easing program would swamp the fixed-income market, creating a layer of price-insensitive demand that supposedly would cause bond prices to rise further and lead to even lower yields across the maturity spectrum.

This extremely bullish consensus expectation, however, was quickly proved mistaken. The 10-year benchmark German bund yield has surged since mid-April, briefly topping the 1% mark in June and dragging yields higher in its wake. We think much of this movement reflects the unwinding of what had become a crowded and leveraged trade. The ferocity of the rate rise also highlights how quickly supposedly deep markets can turn illiquid, even in the absence of severe economic stress.

As expectations for economic growth improve in Europe and fears of deflation recede, we should see further upside movement in European yields over time. As seen in Exhibit 1 on the following page, it wasn't too long ago (August 2013) that German bund yields were trading closer to 2%. On the other hand, it's simply too soon to say with any strong conviction that Germany's bond market—or any other developed-country's bond market—has entered a long-term bear-market phase. Over the past 25 years, there have been five other occasions when the German 10-year bund climbed a percentage point or more. Those episodes obviously did not change the longer-term trend.

© 2015 SEI

Exhibit 1: Descent into the Abyss

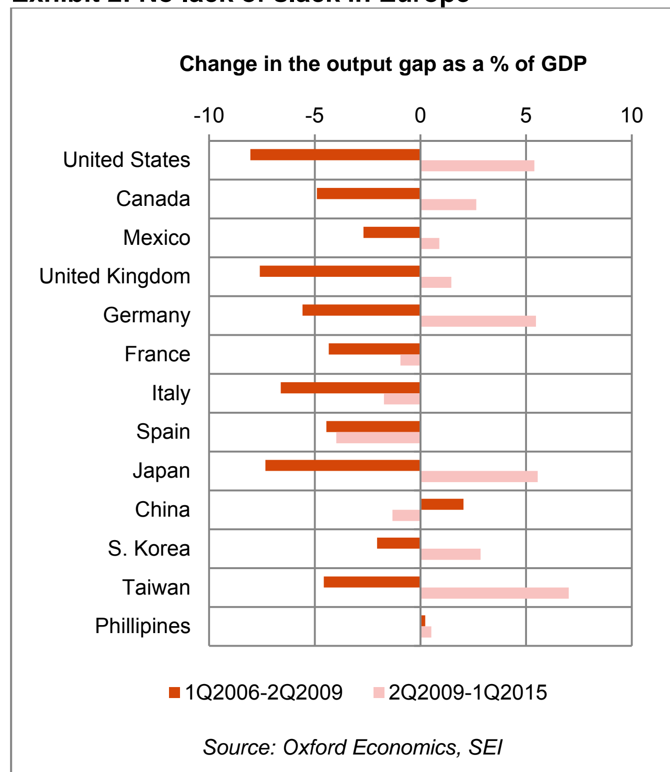


Source: Tullett Prebon Information, SEI

Until inflation in the eurozone accelerates in a meaningful way, it's hard to see a sustained rise in bond yields. Although the headline Consumer Price Index (CPI) in the eurozone popped back into positive territory, the core inflation rate (which excludes energy, food and alcohol) continues to run at a relatively low 0.9% on a year-over-year basis — certainly well below the rate that should worry policy makers. Even in Germany itself, where the economy has been more robust and wage growth has been correspondingly stronger, the core inflation rate remains around 1% year over year.

We think it should be a few years before inflation in the eurozone even reaches the ECB's target of 2%, much less surpass it in a worrisome way. Economic slack remains substantial, undercutting attempts to raise wages and selling prices. Exhibit 2 shows the change in the output gap (the difference between a nation's actual and potential output of goods and services) for several advanced and developing countries. Output gaps for nearly all countries in the chart (with China and the Philippines as the exceptions) experienced a big jump between the first quarter of 2006 and the second quarter of 2009, as the global downturn slashed employment and capacity utilization rates. Most of the countries, however, have since experienced a narrowing of their gaps, as expressed in Exhibit 2 as a percentage of gross domestic product (GDP). The main exceptions were the major European countries, including France, Italy and Spain. We expect the large amount of excess capacity in Europe to continue limiting upside pressure on inflation in the region for several years to come.

Exhibit 2: No lack of slack in Europe

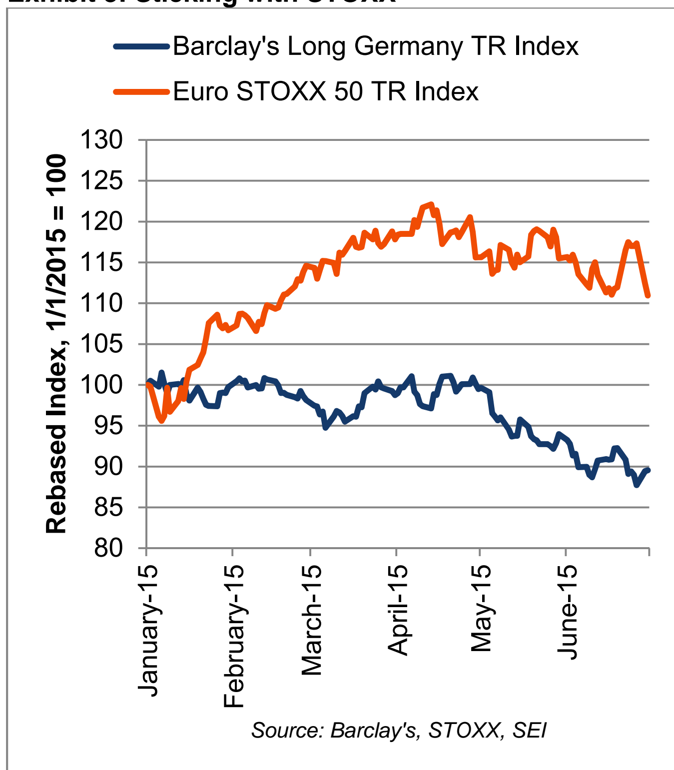


Source: Oxford Economics, SEI

Even in the absence of a major inflation flare-up, however, the European bond market has become a more volatile place. As ECB President Mario Draghi said at his press conference on June 3, "But certainly one lesson is that we should get used to periods of higher volatility. At very low levels of interest rates, asset prices tend to show higher volatility; and in terms of the impact that this might have on our monetary policy stance, the Governing Council was unanimous in its assessment that we should look through these developments and maintain a steady monetary policy stance." Investors, in other words, have been warned. European bond markets are no longer a one-way bet.

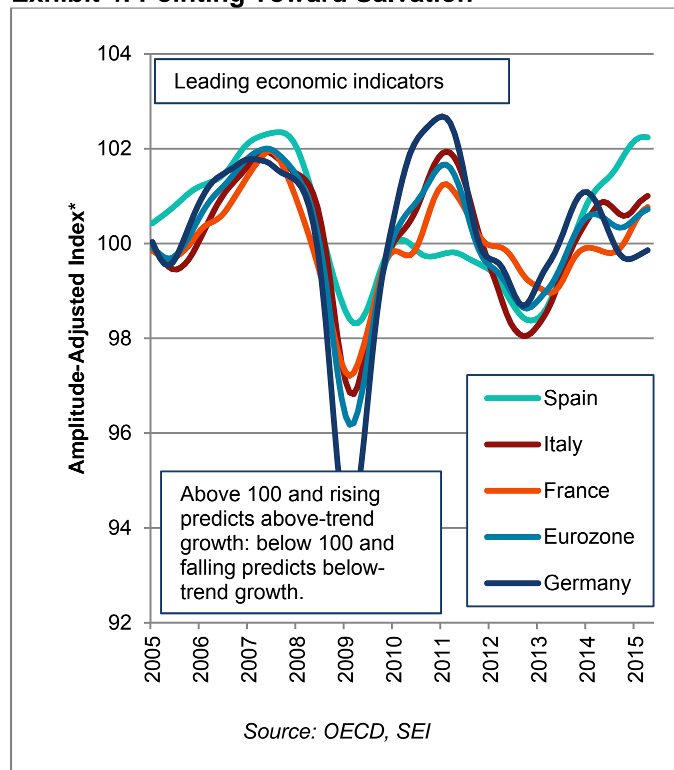
It shouldn't be surprising that European equities have also pulled back as bond yields have rebounded. However, given the sharp move in bonds (not to mention the uncertainty surrounding Greece), we think the equity correction appears rather tame up to this point. The Euro STOXX 50 Index, as shown in Exhibit 3, recorded a peak-to-trough decline of 9.1% in total-return terms between mid-April and late-June. That decline is significantly less than the 13.2% loss registered by long-dated German bunds. Eurozone equities, moreover, rallied strongly toward the end of June in expectation of an agreement between Greece and its creditors, leaving the Euro STOXX 50 Index more than 10% ahead of its beginning-of-the-year level in total-return terms.

Exhibit 3: Sticking with STOXX



Source: Barclay's, STOXX, SEI

Exhibit 4: Pointing Toward Salvation



Source: OECD, SEI

The 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. The sharp decline in the euro from year-ago levels, of course, has been a big help for exporters. That noted, eurozone exports within the currency zone have climbed more strongly than exports to destinations outside the currency zone. This is a sign that internal demand is picking up. The collapse in oil prices has increased consumer confidence and raised real incomes, even though labor-market gains remain subdued. In addition, credit constraints continue to ease at a time when demand for loans is increasing, even in the periphery countries of Spain, Portugal and Italy. The ECB's aggressive monetary prescriptions deserve much of the credit. The liquidity provided to banks by the central bank's asset-purchase program is being used primarily to extend new loans to businesses. Banks are no longer seeking funds merely to recapitalize their balance sheets. In other words, the lending transmission mechanism is slowly starting to revive.

When it comes to Europe, we think it's best to look past the last few months of market volatility. As the leading economic indicators clearly show in Exhibit 4, Europe as a whole is in expansion mode. Spain, Italy, Ireland (not shown) and France appear to be leading the way. Although Germany's economy is running below trend, according to the Organisation for Economic Co-operation and Development's (OECD) amplitude-adjusted measure, it does appear to be inflecting higher.

Although the euro has strengthened in recent months, we see this as a temporary, countertrend movement. In our report last quarter, however, we warned that such a counter-trend movement was quite possible, in view of the extreme positioning of speculators who were betting that the U.S. dollar would continue its sharp move higher. The most recent numbers suggest that currency traders remain overly bullish on the dollar; although long positions in the euro are finally beginning to unwind. As long as this unwinding process continues, the dollar's value may remain under downward pressure. Once this adjustment in positioning is achieved, however, the impact of diverging interest-rate policies should come back to the fore; we think the euro eventually could fall to parity against the dollar.

There are, of course, headwinds that could blow the European recovery off course. Greece remains the biggest problem. Granted, the country is small economically and European banks are less exposed to a Greek default than they were a few years ago, when the entire euro project seemed to be in jeopardy. This is why the daily ups and downs of the negotiations between the Greek government and the troika (the European Commission, the European Central Bank and the International Monetary Fund) have not led to more serious financial-market gyrations.

The Greek government's decision at the end of June to hold a referendum on July 5 has further muddied the waters. The country was not able to repay loans to the International Monetary Fund (IMF) on June 30, and the

© 2015 SEI

bailout agreement with the rest of Europe has officially lapsed. Emergency liquidity assistance (ELA) from the ECB to Greek banks has been frozen. Thus, the government had no choice but to close the banks and impose draconian capital controls until the referendum is held. The Greek economy will most likely come to a standstill without a functioning banking system.

Unfortunately, even if the referendum is held as planned, it may not provide a clear resolution to the crisis. Even if voters vote “yes” to the conditions set by its creditors, the Greek Parliament must still approve the package. There’s no guarantee that Prime Minister Alexis Tsipras has the votes. The more radical elements of Syriza, the left-wing political party, would actually welcome a Greek default and an end to eurozone membership.

As economic chaos deepens, it would not be surprising to see the government fall. What sort of coalition takes its place and how, is anyone’s guess. Another general election could take weeks to organize, time the Greeks do not have.

If there is a regime change, there will be the hope that a new bailout agreement can be reached. However, the need for further austerity measures — including additional pension cuts, tax increases and labor- and product-market reforms — will still be part of any package. In the absence of what will be mostly a Greek capitulation, the country will need to leave the eurozone club and reissue drachmas. A prolonged period of economic upheaval will likely ensue.

Even under the best of circumstances — a regime change that leads to a quick agreement between Greece and its creditors — we question the country’s ability to service its debt without a substantial debt restructuring. Without a debt write-down, another agreement should prove to be just a temporary stay of execution.

Judging from the rise in currency in circulation as a percentage of GDP (approaching 65% at the end of March this year versus 58% at the end of March 2014, as shown in Exhibit 5), the Greek people have already prepared for the worst. Bank deposits have also suffered a major run this year, as people hide their cash in their mattresses or buy tangible assets. Luxury car sales, for example, have been extraordinarily robust this year. Until there is substantial debt forgiveness in exchange for the economic reforms demanded by creditors, this particular Greek drama will have more acts ahead.

Exhibit 5: Cash is King in Greece

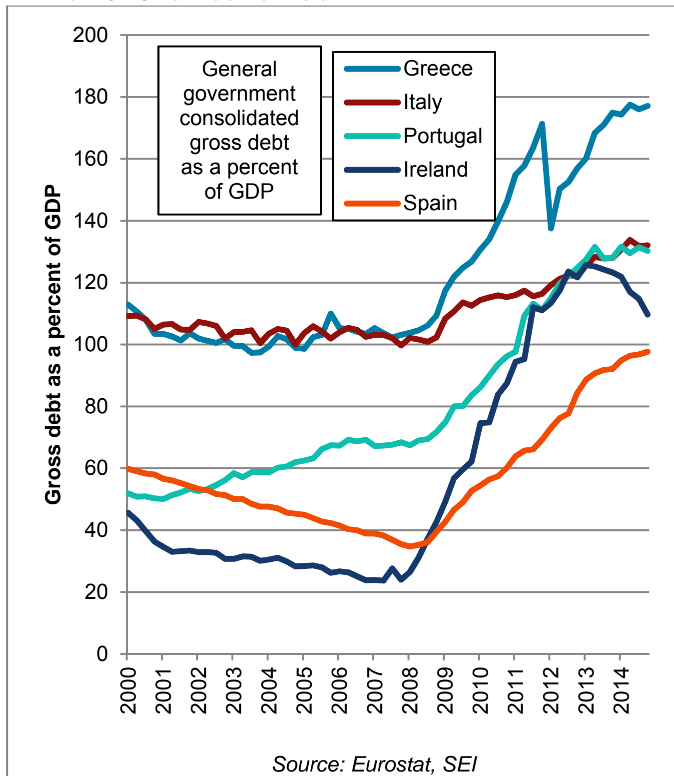
Source: Bank of Greece, SEI

Beyond Greece, debt also remains a heavy burden on the other periphery countries. As Exhibit 6 on the following page illustrates, very little progress has been made reducing periphery government debt as a percent of GDP, with Ireland being the main exception. We think this shows the real limits of austerity. It’s almost impossible to reduce the debt burden in a no-growth economy. Increases in the denominator of the debt-to-GDP ratio are a necessary condition to get Europe on firmer fiscal footing. For too many years following the financial crisis, however, the Europeans waged a wrong-headed fight against reflation, fearing that structural reform would go by the wayside if the periphery countries were allowed to stimulate their economies through fiscal policy. We are hopeful that the shift in government policies seen in recent months toward less austerity and more monetary expansion will stabilize debt trends in the near term. However, the sheer level of debt remains formidable in the periphery — which will likely limit Europe’s growth potential and keep the region vulnerable to economic setbacks and dramatic shifts in investors’ risk perceptions and tolerances.

Europe’s decision makers are assuming that the crisis in Greece is not a “Lehman Moment.” We agree with this assessment. The risk of contagion has been reduced dramatically in recent years. Cross-border lending to Greece has declined by well over 90% — and almost all of the country’s debt is now held by official institutions that have the capacity to absorb portfolio losses. Most critically, the ECB has taken on the traditional role of central banks, functioning as lender of last resort during financial and economic crises. It has the legal authority and tools necessary to respond to threats that materialize within the eurozone and from further events in Greece.

© 2015 SEI

Exhibit 6: Chained to Debt



Source: Eurostat, SEI

From "Grexit" onto "Brexit"?

Although an imminent Greek default and possible exit from the eurozone have taken center stage in recent months, investors need to keep their eye on a potentially more important exit — that of the U.K. from the European Union (EU). The stunning victory of the Conservative Party in May's general election makes it a certainty that a referendum on the country's membership will be held by the end of 2017 (with the largest bets on an October 2016 vote). Prime Minister David Cameron has already been making the rounds of Europe's capitals, arguing the case for treaty change. The main points of contention between the U.K. and rest of the EU revolve around immigration into the country, especially from Poland and other Eastern/Central European countries; a demand to give national parliaments a veto over EU legislation; and enshrining into law a halt to further moves toward political union. It's hard to see how these demands can possibly be met. Any treaty changes need to be approved unanimously, and several countries would choose to hold popular referendums themselves. That Pandora's Box is not going to be opened.

Opinion polls suggest that a majority of U.K. citizens are in favor of maintaining the status quo. However, such views are generally weakly held. Given U.K. citizens' long-standing skepticism of Europe, nothing should be ruled out. In any event, it's certainly hard to believe opinion polls in the aftermath of the May 7 general election. We anticipate that U.K. financial markets and sterling will become increasingly volatile as the referendum date draws closer.

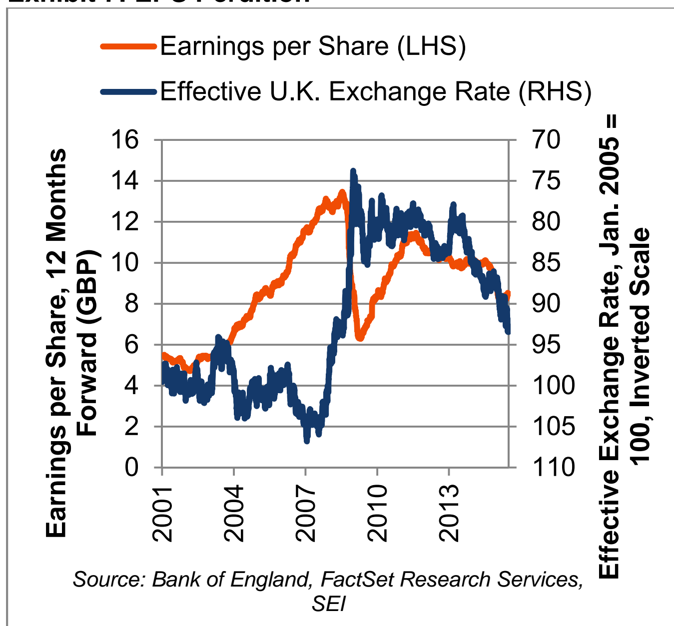
Just as stunning as the Conservatives' victory was the landslide in favor of the National Scottish Party. Scottish independence, like a Brexit from the EU, is not in most citizens' interest. But this is an objective view on a topic that elicits intense emotion. It's possible that another referendum on Scottish independence will be held sometime in the next several years, leading to a different result versus last September's outcome — especially if the U.K. actually opts out of the EU, since Scottish residents are strongly in favor of staying in.

In our opinion, the Conservatives' victory in May showed that economic issues were foremost in the mind of the electorate. The U.K. experience in recent years has been similar to that in the U.S. Growth has been good, but not great. The unemployment rate has come down sharply, but at the cost of lagging productivity and stagnant incomes. London is booming, but most of the rest of the country is just slogging through. Inequality issues are becoming more contentious.

We still see a need for a weaker pound, although the currency has gone in precisely the opposite direction since the elections. The country's current account deficit amounts to more than 5% of GDP, near a postwar record. By contrast, Germany sports a current-account *surplus* of more than 8%. A depreciation of sterling against the euro may be hard to achieve, however, as long as the ECB is engaging in an aggressively expansionary quantitative-easing policy and interest-rate differentials favor U.K. assets. The earnings of publicly traded companies in the U.K. will probably continue to trend lower as a result, as shown in Exhibit 7 on the following page.

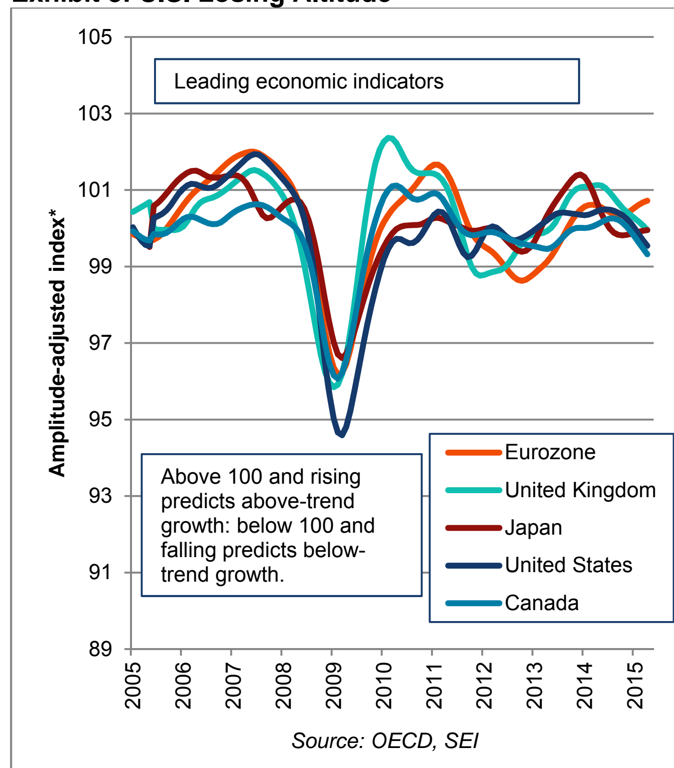
© 2015 SEI

Exhibit 7: EPS Perdition



Source: Bank of England, FactSet Research Services, SEI

Exhibit 8: U.S. Losing Altitude



Source: OECD, SEI

We therefore disagree with the notion that the Bank of England's (BoE) Monetary Policy Committee will quickly follow the U.S. in commencing an interest-rate up-cycle. Since the Conservative Party's victory points toward a somewhat austere fiscal policy in the years ahead — whether or not Chancellor of the Exchequer George Osborne succeeds in his goal of enshrining a balanced budget requirement into law — it seems sensible for the BoE to maintain an expansionary monetary policy at a time when growth prospects are modest, inflation is relatively low and there is an urgent need to achieve a better balance in the country's external accounts with its biggest trading partner.

The U.S. Economy: Still in Limbo?

"All hope abandon, ye who enter in!" -Inferno, Canto III

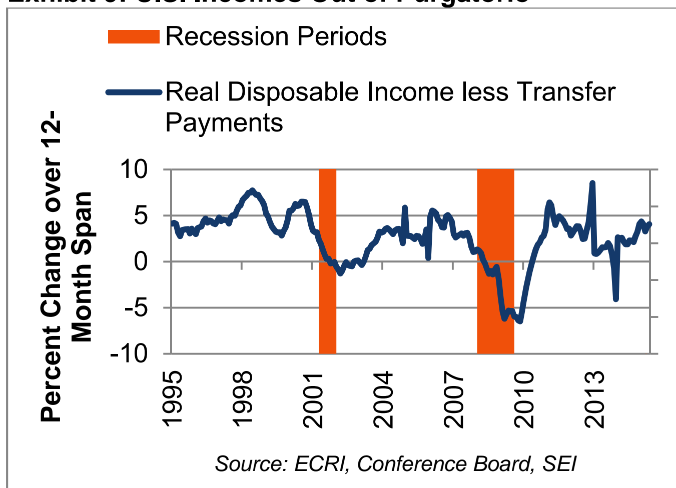
The quote above pretty much summarizes the commentary being published about the U.S. economy. True, the data for the first half of the year have generally been disappointing, with GDP falling into negative territory during the first quarter. Even a second-quarter rebound in economic growth to a 3% annualized rate would leave GDP only 2.3% above the year-ago level. As seen in Exhibit 8, leading indicators by the Organization for Economic Cooperation and Development (OECD) are signaling below-trend growth, a contrast to improving trends in Europe and (to a lesser extent) Japan. Industrial production has either held steady or posted declines in each month from December through May. New orders for capital goods have declined sharply, as the recession in the oil-producing areas of the country deepens, while exports have sagged in response to the dollar's appreciation. Economy-wide profits, as measured in the national accounts, have also lost their upward momentum.

This litany of economic woe notwithstanding, we would not advise abandoning hope. In particular, we think much of the economic data in recent months may be overstating the extent of U.S. weakness. As we pointed out at the end of the first quarter, severe winter weather, the West Coast port strike, dislocations caused by the oil price collapse, and turmoil in currency markets have all played a role in depressing economic activity. While some of these factors are more temporary in their impact than others, there is good reason to expect a decent rebound in GDP growth during the remainder of the year.

In particular, consumer spending should pick up nicely in the months immediately ahead. First, incomes are rising. Exhibit 9 on the following page reveals that personal income (excluding government transfer payments) climbed 4.17% in inflation-adjusted terms over the past 12 months. 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. Granted, much of this appreciation has accrued to high net-worth households. But seriously delinquent mortgages as a percentage of all mortgages have fallen too (from a high of 9.67% at the end of 2009 to 4.24% as of the first quarter).

© 2015 SEI

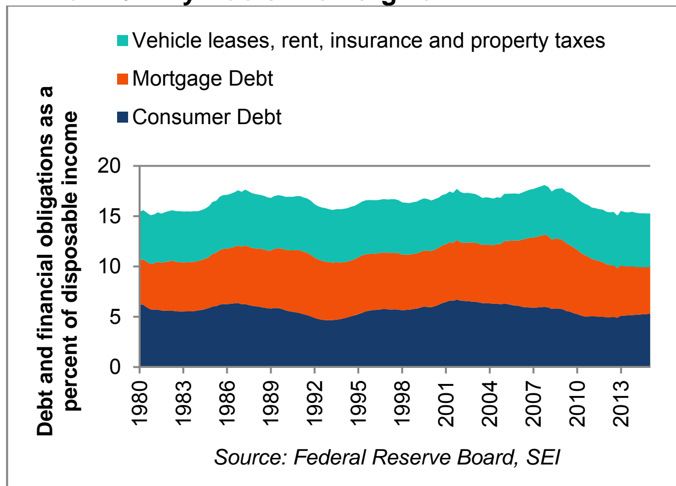
Exhibit 9: U.S. Incomes Out of Purgatorio



Source: ECRI, Conference Board, SEI

At the current pace of improvement, the delinquency rate should be back to pre-crisis levels of less than 2% by the first half of 2017. This is a clear sign that the pressure on the country's middle class is easing. Third, households now are in a position to take on more debt. Exhibit 10 shows that household debt service and financial obligation ratios are at their lowest levels since the Federal Reserve (Fed) began collecting this data in 1980.

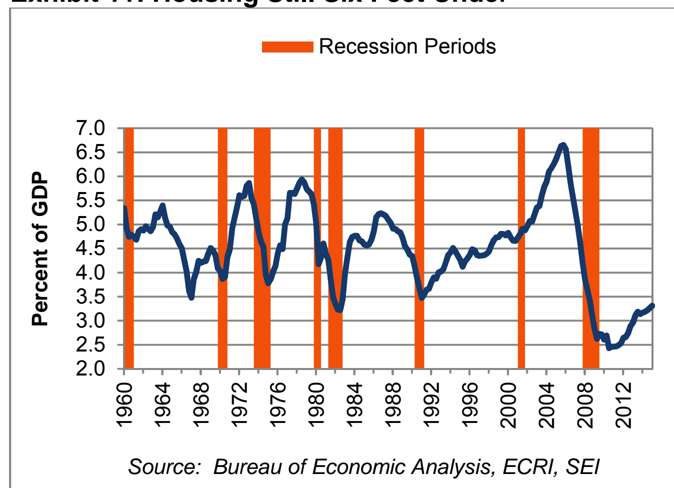
Exhibit 10: Thy Debts Are Forgiven



Source: Federal Reserve Board, SEI

Consumer credit, mostly reflecting the growth in student and auto loans, has already accelerated. Growth in mortgage debt, on the other hand, remains rather subdued. This is consistent with the atypically slow recovery in the housing sector. Expenditures on residential housing have risen to 3.3% of GDP, up from 2.5% in 2010. This improvement pales against the historical trend highlighted in Exhibit 11. While we do not expect housing to experience a pre-2005 boom in activity, we do expect a continuation of the recovery that has been in place for the past several years.

Exhibit 11: Housing Still Six Feet Under



Source: Bureau of Economic Analysis, ECRI, SEI

In this mild-to-moderate growth scenario, corporate profits and cash flow should grind their way higher. When stock buybacks are added into the calculation, we think earnings per share can still approach upper-single-digit growth rates. Companies are finding ways to overcome the headwinds of a sluggish economy and weak top-line growth. While revenues of the companies that make up the S&P 500 Index declined by more than 3% year over year in the first quarter (+2% when excluding energy), they still were able to post a 2% gain in earnings per share (+10% when excluding energy). This ability to manage costs during a challenging quarter far exceeded expectations at the start of the earnings reporting season. Earnings per share surprised to the upside by seven percentage points — almost double the typical experience.

The Fed Gets Closer to Lift Off

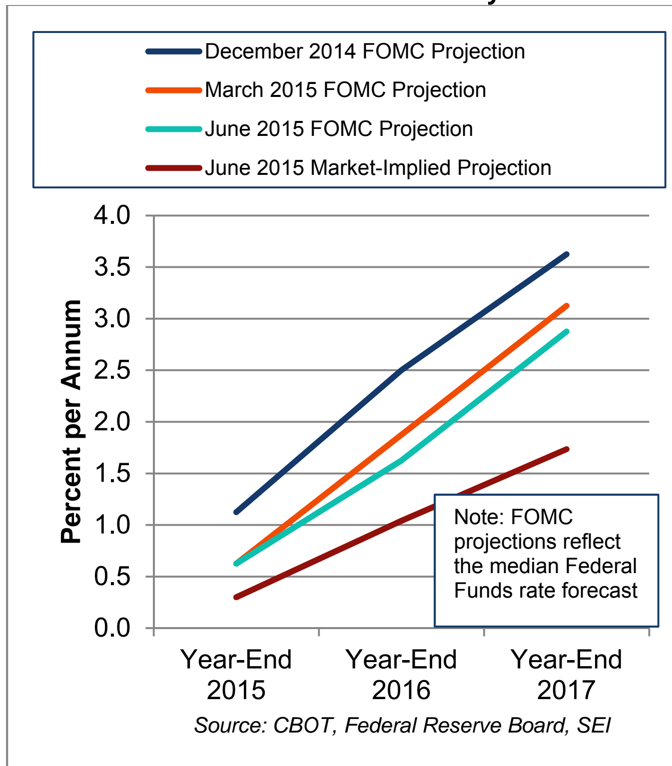
Usurers inhabit Hell's Seventh Circle in Dante's poem, but we do not think anyone would ever accuse Fed Chair Janet Yellen of usury! In her latest press conference, she again reiterated the Fed's approach of being data dependent and patient when it comes to normalizing interest-rate policy. In our opinion, most decision makers at the Fed have no desire to anticipate a rebound in economic growth or inflation too far in advance. On the contrary; we believe a majority of members on the Federal Open Market Committee (FOMC) are willing to risk being a little behind the inflation curve in order to avoid a premature tightening of policy.

They certainly do not want to repeat the mistake of Jean-Claude Trichet, predecessor of ECB President Draghi. Trichet pushed through two policy rate hikes between April and August 2011. That was enough to snuff out a fledgling economic recovery in the eurozone and drive the periphery countries deeper into crisis. Although the U.S. is currently in a better position to withstand a rate hike than Europe was in 2011, the tendency is definitely to err on the dovish side.

© 2015 SEI

Investors' immediate reaction to the Fed's June policy statement was a bit counterintuitive, however. Although the FOMC meeting minutes and Chair Yellen's press conference did not change the consensus view that the first rate hike could come in September, equity prices pushed higher, bond yields fell and the dollar weakened to five-month lows. It's true that the members of the FOMC reduced their economic projections for 2015, but this merely reflects the fact that GDP for the first half of the year was much weaker than expected. Projections for the federal funds rate (the so-called "dots") were also reduced meaningfully, with fewer FOMC members expecting two funds rate hikes during this calendar year. However, as indicated in Exhibit 12, the market-implied expectation for the federal funds rate continues to run well below the Fed's expectations.

Exhibit 12: Choose Your Path Carefully



Source: CBOT, Federal Reserve Board, SEI

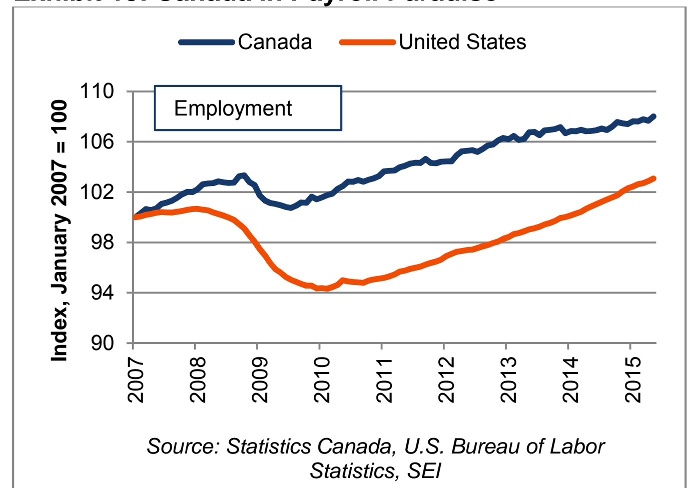
This large divergence between what the FOMC is projecting and what futures traders are expecting is hard to explain. It suggests that financial markets are vulnerable to a significant rise in volatility if traders decide that the federal funds rate will move higher and faster than currently anticipated — which is more along the lines of the FOMC's projected path. It needn't end the current cyclical bull market in equities, but it would provide the catalyst for a sharp correction.

More Ice than Fire in Canada

North of the U.S., the economy appears somewhat chillier. Canada also endured a negative first-quarter GDP. However, the impact of severe winter weather appears to be a flimsier excuse than it might be in the U.S. We believe most of the problem has to do with the collapse in oil prices. Since energy and materials make up a larger proportion of business activity in Canada, trends in commodity prices have a correspondingly more potent impact. In the first quarter, for example, the contraction in fixed investment accounted for almost all of the 0.6% decline in inflation-adjusted GDP (measured on a quarter-to-quarter annualized basis). By comparison, although capital spending in the U.S. oil patch also suffered a notable decline, fixed-investment contributed to GDP. In the U.S., the deterioration in net exports more than accounted for the quarterly contraction in first-quarter GDP.

Employment growth in Canada has lagged that of the U.S. by a wide margin since 2012. This partially reflects the fact that the 2008-to-2009 recession in Canada was far less devastating than in the U.S. As shown in Exhibit 13, employment did not peak until October 2008, and fell only about 2% on a peak-to-trough basis. U.S. payroll employment, by contrast, peaked in December 2007 and then fell a precipitous 6.3%. Employment in Canada is now 4.5% above its prior peak, while U.S. employment is just 2.3% above its previous peak.

Exhibit 13: Canada in Payroll Paradiso



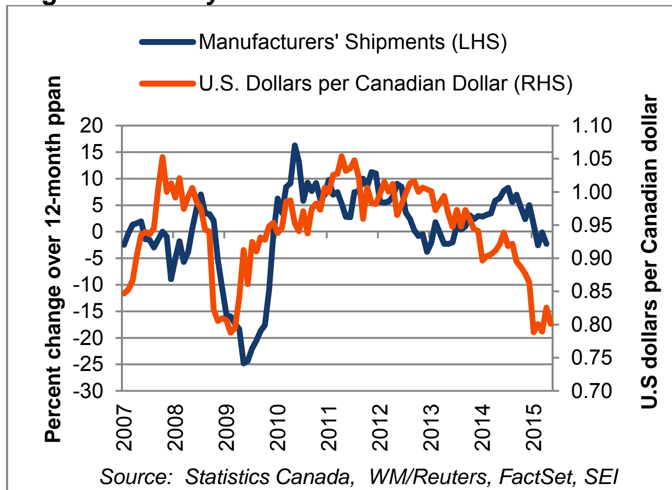
Source: Statistics Canada, U.S. Bureau of Labor Statistics, SEI

Canada's relatively good performance during the 2008-to-2009 crisis notwithstanding, it's clear that economic growth is fading. The recession in the oil-producing provinces, especially Alberta, should have a national impact. This setback comes at a time when consumers in Canada are over-leveraged, with household debt around 95% of GDP versus 67% in the U.S.; in 2009, the household debt ratios of the two countries were both 86% of GDP.

Despite a welcomed decline in energy costs, manufacturers have not yet taken up the slack created by the downturn in the oil sector and other extractive industries. Shipments of manufactured goods have slipped by more than 2% in the past year, a soft patch

similar to the one endured in late-2012 and early-2013 (Exhibit 14 on the following page). In that earlier period of manufacturing weakness, the Canadian dollar weakened against its U.S. counterpart and equity prices badly lagged the U.S. in local-currency terms.

Exhibit 14: Economic Weakness Begets Currency Weakness



Source: Statistics Canada, WM/Reuters, FactSet, SEI

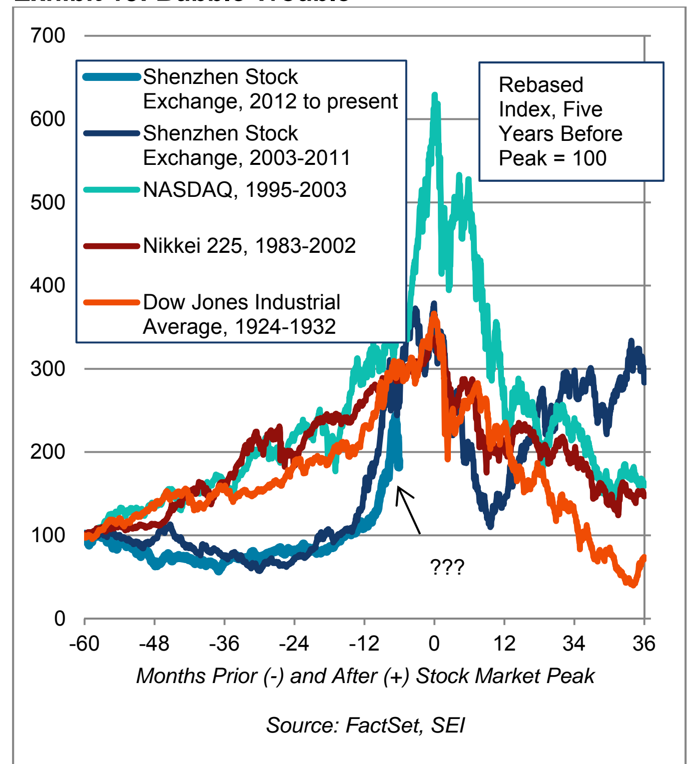
Given this backdrop, we expect economic policy in Canada to follow a relatively expansionary course. We understand the concerns surrounding the prevalence of a structurally higher inflation rate and the frothiness of real estate markets in cities like Vancouver and Toronto. But we think the downturn in oil and mining will trump inflation worries. Until oil and other commodity prices strengthen meaningfully, and/or manufacturing activity rebounds in response to the Canadian dollar's sharp depreciation against the U.S. dollar, we look for the Bank of Canada to drag its heels when it comes to following the Fed's push to normalize short-term interest rates.

China Equities Bubbling Like the River Styx… or Drowning in It?

One of the more spectacular, unexpected developments in the past quarter has been the performance of mainland Chinese stocks. This comes at a time when economic growth has slowed to a mid-single-digit pace. That growth may still be faster than most of the rest of the world, but it pales against the low-to-mid double-digit gains achieved by the country during the decade leading up to 2012. True, government policy has turned more expansionary this year. Bank reserve requirements and interest rates have been eased. Fiscal policy has also been re-geared to help local governments, as efforts are made to rein in borrowing that has created the country's infamous "ghost cities" and excess capacity in favored heavy-industry sectors.

Exhibit 15 highlights the boom in Chinese stock prices since 2012, as measured by the Shenzhen Stock Exchange, and how the current experience compares to other bubble markets. The trajectory of the Chinese market over the past six months is similar to the NASDAQ Composite Index's final 1998-to-1999 boom phase. It also eclipses the rate of gains for the Dow Jones Industrial Average Index during the late-1920s, those of the Japanese Nikkei Index in the late-1980s—and even the Shenzhen Stock Exchange itself in 2006 and 2007.

Exhibit 15: Bubble Trouble



Source: FactSet, SEI

Although the markets in China became more turbulent toward the end of June, dropping more than 20% in less than three weeks, we simply cannot rule out that prices will turn around and resume their journey into the stratosphere — in a frenzy of buying momentum, divorced from the fundamentals. It's happened before, in China and elsewhere. In China's case, the eventual opening of the country's local stock markets to foreign investors can justify a long-term bullish view. Gavekal Dragonomics, an economic consultancy based in Hong Kong, is among the foremost of the China bulls. It expects strong demand for mainland Chinese A shares when they become a part of emerging-market and all-country benchmarks. In addition, it argues that internationalization of the renminbi and liberalization of the capital account could lead to the same kind expansion in market capitalization that Japan experienced after that country liberalized its capital account in 1980.

© 2015 SEI

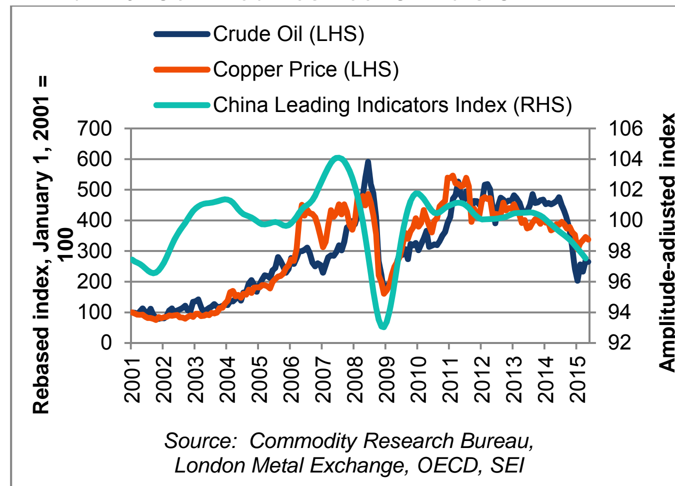
One near-term catalyst toward the goal of making the renminbi a reserve currency, according to Gavekal, would be its inclusion, perhaps later this year, in the IMF's Special Drawing Rights basket.

There's no denying that China's influence is on the rise, both militarily and through the use of "soft power." It has rolled out the Asian Infrastructure Investment Bank as a direct competitor of the U.S.-led World Bank. It also plans to undertake huge direct investments in its Asian neighbors over the next decade as it builds out railways, pipelines and ports. These moves will pose a tremendous geopolitical challenge to the U.S. at a time when the nation is fiscally challenged and its political leaders are divided on how deeply it should be engaged with the rest of the world.

Although China appears to be on a roll, we feel compelled to point out how economies and financial markets can take unexpected twists and turns. In particular, we view the command-and-control aspects of China's economic structure as a critical known unknown. As we've pointed out before, the government is taking steps to improve the balance between investment and consumption. Progress is slow, however; the deceleration of growth in the economy has the potential to rekindle social tensions if the rising aspirations of China's middle class are not met.

We still believe that the trend in commodity prices is the best real-time barometer of China's economic health, as well as the health of many developing economies dependent on China's appetite for imports. Oil and other commodity prices are still quite depressed, as Exhibit 16 shows. Although oil demand continues to grow, the pace of gain appears to be decelerating as the country's overall growth slows and energy efficiency improves. Although China's trade data can be quite volatile, owing to Lunar New Year seasonal adjustment problems and the invoicing accounting games played by companies, the evidence of a flattening trade growth since 2013 is convincing — and dovetails with other data indicating a slower growth trajectory for the country. 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.

Exhibit 16: Commodities Feel China's Chill



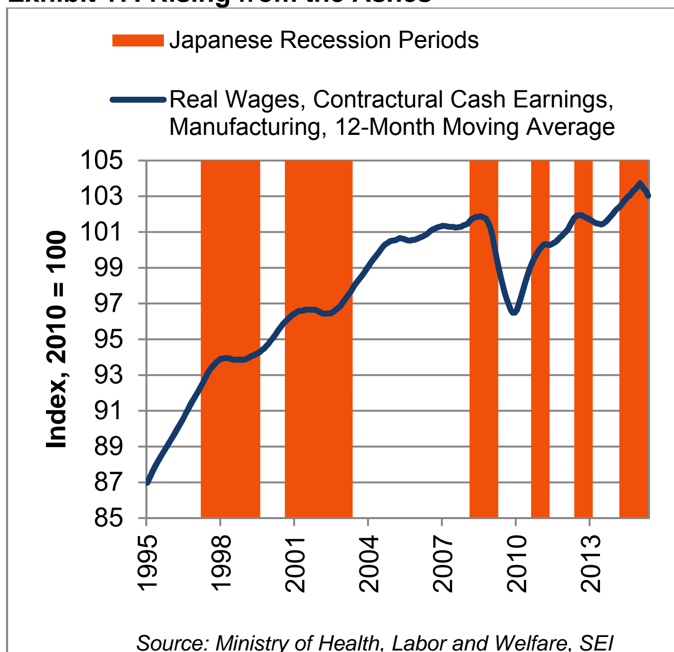
Source: Commodity Research Bureau, London Metal Exchange, OECD, SEI

Japan's Redemption and Resurrection

Japan's economy seems to be coming back to life, limb by limb. Economic growth accelerated in the first quarter of the year to a 3.9% annualized rate, although real GDP is still down from a year ago and only remains on par with the previous cyclical high achieved in 2008. Gross fixed investment was particularly strong, following three consecutive quarters of decline. Machine tool orders reached their highest reading in nominal yen terms since 2008. Trade is also a bright spot. The decline in oil prices has been a godsend for households and businesses in the energy-resource-poor country. Although the oil-price collapse has prolonged the deflation trend, this is good deflation. The merchandise trade deficit has improved immensely.

Prime Minister Shinzo Abe has also experienced some success in cajoling businesses to raise salaries and wages. Real incomes have rebounded smartly off their lows in recent months, but remain at a very depressed level — advancing just a cumulative 5.7% over the past 10 years (Exhibit 17 on the following page). There is still a lot to do, and the government knows it. The Bank of Japan (BOJ) continues to engage in qualitative and quantitative easing (QQE), although BOJ Governor Haruhiko Kuroda and other monetary policymakers have expressed resistance at getting any more aggressive than they already are. By the same token, we see no sign that they will taper their bond-buying program anytime soon.

Exhibit 17: Rising from the Ashes



Source: Ministry of Health, Labor and Welfare, SEI

The Abe government continues to do what it can to encourage growth and put an end to deflation. QQE and aggressive equity purchases by the Government Pension Investment Fund (GPIF) have given strong technical support to the stock market. Indeed, the Tokyo Stock Price Index advanced nearly 17% in the year to date on a total-return basis versus 1.27% for the S&P 500 Index. Further gains in Japanese equities are possible, on both an absolute and relative basis, in our opinion. In addition to the improving economy, and the support to equities provided by the BOJ and GPIF, investor-friendly changes in corporate governance and a focus on returns on equity are serving as catalysts for the bull market. Meanwhile, companies' earnings per share continue to grow at a strong and consistent rate — in sharp contrast to the more erratic patterns seen in the U.S., Europe and other developed countries. Finally, corporate Japan's valuation metrics remain quite attractive versus those of other major stock markets; although Japan's strong price performance has somewhat reduced the valuation disparities.

In our opinion, there still is a healthy skepticism regarding Japan – and with good reason. At 210% of GDP, Japan's central-government debt ratio is among the highest in the world and its population is among the oldest. Its culture is highly resistant to change. In addition, policy mistakes are magnified in an economy as becalmed and deflation-prone as Japan's. Last year's national sales tax increase drove the economy into a ditch from which it is only now emerging. The equity market would probably react badly to a premature tightening of monetary policy or serious backsliding in the economic and financial reform effort.

We would also be concerned if the Trans-Pacific Partnership (TPP) agreement foundered as a result of U.S. or Japanese politics. We view the TPP as a geostrategic initiative just as much as an economic one. The TPP would not only strengthen economic ties across 12 countries that represent 40% of world GDP, it would also act as an economic counterbalance to an increasingly assertive China. Finally, we view the TPP as a lever that can be used by Prime Minister Abe to open up areas of the Japanese market that have atrophied as a result of corporate cronyism and unfair political advantage. It would force the country to undertake politically sensitive reforms within its agriculture and services sectors, labor markets and regulatory practices. We would have to reconsider our constructive view on Japan in the event that discussions collapsed as a result of political bickering and the power of entrenched interests.

Strategy Positioning

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. 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.

U.S. large-cap earnings revisions have rebounded at a slower rate than those of small caps, which rallied late in the quarter. Managers have a pro-cyclical orientation, while also holding higher-than-normal levels of cash. Energy underweights have been trimmed; we are not overweight in many areas, but our deeper value, pro-cyclical positioning comes from there. Defensive and low-volatility valuations are still high, though less so than earlier this year.

International equity funds remain pro-cyclically positioned, with an emphasis on smaller companies and momentum. Emerging markets still exhibit promise, especially in the wake of sharp currency depreciation. But positions—specifically overweights in Brazil and Turkey—have been scaled back. Managers favor Asia, with underweights to Korea, Taiwan and Japan at their lowest levels in a long time. China has moved toward a neutral weight, as managers take exposure off the table amid the country's record stock-market highs. The Australian financial sector is underweight, while European exposure has been concentrated in value-oriented opportunities.

In our Asia equity funds, investment managers are constructive on Japan from a corporate, fundamental perspective more so than at a macro level. Japanese banks are undergoing consolidation, which presents

opportunity. Managers are focusing on security selection in China among a narrow opportunity set, with an emphasis on the long term despite retail-investor-driven short-term volatility. China's deceleration story is weighing on other countries, especially Australia, and on commodity markets. Managers consider Singapore overvalued, particularly with neighboring countries like Malaysia adversely affected by weak commodity prices.

European and U.K. equity managers are pro-cyclical, as defensive names remain expensive. European managers are inclined toward value, but have been easing off. They are focused more on security selection than macro issues. The rally that resulted from central-bank driven asset purchases enabled managers to upgrade underperforming holdings in favor of quality healthcare and consumer staples names at lower valuations. The U.K. market has been driven by stock specifics, where managers continue to favor momentum.

Our core fixed-income managers have noted rising volatility, as rates began increasing amid reduced liquidity. A steepening yield curve has recently run counter to our flattening orientation. Managers still like financials and are underweight sectors with higher event risk (industrials and utilities). Non-agency mortgage backed-securities (MBS) remain attractive, while agency MBS still do not appear to be a great value. Commercial MBS and asset-backed securities have continued to provide consistent value through a range of market environments. Managers are underweight sovereigns, especially emerging-market issues, while Treasury inflation protected securities appear inexpensive. Core fixed income is essentially duration-neutral right now.

In the U.K. and Europe, fixed-income managers have recently been extending duration in response to the German yield curve. They also have been reducing credit risk by selling cash bonds rather than using derivatives. Managers have been reluctant to do this in the past because there was so much demand for high-quality credit; but they expect a real selloff in the near future, and suspect an opportunity to repurchase at better prices. Managers are keeping a watchful eye on developments in Greece; an aggressive overweight to the periphery has been reduced, and some managers are now underweight.

Positioning in our U.S. high-yield funds has been relatively consistent, with a lower average dollar price and higher yield spread than the benchmark. We remain underweight BB rated issues, with a large overweight in B rated bonds, a 9% allocation to bank loans, and 8.6% to structured credit. We view event risk as a positive; managers are looking for attractive issuers with catalysts. They are overweight leisure, media and technology and electronics. They are underweight to financials (which have extra-long duration and don't offer a lot of value due to strong performance) and energy (where most recent defaults have been concentrated and good credits have rallied). Basic industries is also a large underweight on the perception of high risk and low value. The structured credit portfolio and avoidance of blowups in basic industries have contributed to performance recently. Market liquidity was fine until late in the quarter; problems have been concentrated in exchange-traded fund outflows, but were nowhere near "taper-tantrum" levels.

Our emerging-market debt managers are short duration and underweight hard- and local-currency debt in favor of cash and off-benchmark positions in corporates. Regionally, we are underweight Asia and Europe, slightly overweight Latin America and overweight the Middle East. This results in an underweight to higher-quality countries and overweight to slightly lower-quality countries.

Mexico remains the largest overweight, while managers have been reducing exposure to countries that are vulnerable to external factors and political developments (such as Turkey). Managers are underweight the Russian ruble and have reduced positioning in the Brazilian real and favored Asian currencies (Indonesian rupiah, Indian rupee and Thai baht). We still like Russian and Brazilian local debt despite the currency underweights—we do not like the currencies, but we like their rates market, as yields are attractive compared to elsewhere. Managers still like China, and have moved to an overweight in the Philippines, where growth is good compared to other countries in region and the central bank is not pushing to devalue the currency. Renewed weakness in emerging-market currencies is anticipated. Venezuela remains one of the largest overweights, given the U.S. dollar and current spreads.

Within alternative strategies, net equity-market exposure has increased, but is still relatively modest, while market beta has decreased. We increased our focus on equity-hedge strategies in the past few months, which has helped emphasize opportunities in industrials and technology. Relative-value, event-driven and distressed strategies have lagged, and we have continued to reduce our focus on event-driven in recent months. Activism has been positive, and has begun shifting towards Europe. Structured credit has contributed, while long/short corporate credit has lagged. In relative value, managers have had lower net exposure and, therefore, lower returns. Overall, market volatility has been a positive development for European bond and currency markets, especially in global macro foreign exchange strategies. Market liquidity challenges have not hurt yet, but there is concern; it could cause structural damage when the Fed starts tightening.

© 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 regarding the Funds or any stock in particular, nor should it be construed as a recommendation to purchase or sell a security, including futures contracts. There is no assurance as of the date of this material that the securities mentioned remain in or out of SEI Funds.

For those SEI Funds which employ the 'manager of managers' structure, SEI Investments Management Corporation (SIMC) has ultimate responsibility for the investment performance of the Funds due to its responsibility to oversee the sub-advisers and recommend their hiring, termination and replacement. SIMC is the adviser to the SEI Funds, which are distributed by SEI Investments Distribution Co. (SIDCO). SIMC and SIDCO are wholly owned subsidiaries of SEI Investments Company.

To determine if the Funds are an appropriate investment for you, carefully consider the investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Funds' prospectuses, which can be obtained by calling 1-800-DIAL-SEI. Read them carefully before investing.

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.

- ***Not FDIC Insured***
- ***No Bank Guarantee***
- ***May Lose Value***