The Economic Outlook

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Europe’s debt crisis: A double-dip recession is brewing

Real GDP Compared

Cumulative Percent Change from 2007-08 Peak

-25 -20 -15 -10 -5 0 5 10 15

Source: National Sources, SEI
Europe’s debt crisis: The periphery still in the crosshairs

Government Ten-Year Bond Yields

Percent per Annum

Portugal
Ireland
Spain
Italy

Irish Bailout 10/2010
Portuguese Bailout 4/2011

Source: Thomson Reuters Datastream, National Sources, SEI
Europe’s debt crisis: Markets get a boost from “Super Mario” Draghi

MSCI Europe ex-UK Stock Price

Source: MSCI, SEI
Europe’s debt crisis:
Although the euro has rallied, it remains quite depressed
Europe’s debt crisis: Central banks throw caution to the wind

Central Bank Balance Sheets for Selected Countries as a % of GDP II

- European Central Bank Assets (---) 32.6%
- Bank of Japan Assets (-----) 30.6%
- Bank of England Assets (-----) 24.7%
- U.S. Federal Reserve Bank Credit (-----) 18.3%
- ECB Adjusted Assets* (-----) 21.3%

*Excludes gold, forex reserves, and nonmonetary policy securities

Source: Datastream
U.S. challenges: 
Election-year uncertainty

Source: Real Clear Politics

Moving average of most recent eight polls.
U.S. challenges:
The fiscal cliff becomes an economic cliffhanger

Source: Congressional Budget Office, SEI
U.S. challenges: Slowing profits growth

Note: Profit margin data excludes financials and utilities. Source: Empirical Partners, National Bureau of Economic Research, SEI
U.S. challenges:
No Baby Bull, but no Granddaddy either

Note: Bull markets defined as periods of when the S&P 500 monthly average price index avoids a drawdown of more than 20%. Source: Dr. Robert Shiller, Standard & Poor's, SEI.
U.S. challenges: How much more Bernanke bang for the buck?

Source: Standard & Poor's, Ed Yardeni, SEI
Emerging markets challenges: Cheaper currencies

Trade-Weighted Exchange Rates

Rebased, Jan. 1, 2008 = 100

Brazilian Real
Indian Rupee
Russian Ruble

Source: J.P. Morgan, SEI
Emerging markets challenges:
And better valuations
Emerging markets challenges:
Have yet to bear fruit

Source: MSCI, Standard & Poor's, SEI
The outlook:
Lots of challenges, lots of uncertainty

The good news
• The U.S. economy continues to grow, although the pace is slow
• Equities still appear reasonably priced, but changes in investor sentiment will be an important driver of stock and bond prices
• Monetary policy remains expansionary in most countries
• Inflation fears have eased, although energy and food prices have started rising again
• Emerging markets’ valuations and currencies have fallen dramatically

The bad news
• Europe’s recession is likely to be deeper for longer
• The debt crisis in Europe has worsened, although we are staying alert to policy surprises
• The U.S. election could lead to deeper partisan divisions, making it more difficult to reach needed fiscal compromises at year end
• Emerging markets are struggling as developed markets slow and China traverses its soft patch
• Tensions over Iran’s nuclear capabilities have not disappeared
The PSG active allocation view:
Recommended tilts

We are neutral stocks versus bonds
• We look for stocks to remain in a trading range in the months ahead, although the downside should be contained. Equity markets will have difficulty pushing significantly higher from current levels until political and economic uncertainties begin to ease.
• Core fixed-income has become more volatile, with more downside price potential than upside.

We are neutral high yield bonds over treasurys and investment-grade bonds
• High-yield bond spreads over Treasury have narrowed significantly in the year to date. The absolute yield is approaching previous lows. The potential for capital gains appears limited in the near term.
• Core fixed-income yields do not adequately compensate for inflation.

We are short the euro, long the dollar
• Greece remains in danger of leaving the eurozone, leading to on-going contagion fears. Efforts to resolve the crisis continue to come up short despite the rhetoric coming from ECB President Mario Draghi and other European leaders.
• We expect the European Central Bank to pursue policies that will cause a competitive devaluation of the euro.
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Prepared for use on September 13-14, 2012.