If you think you've seen this movie before, you're right. Some of the major issues troubling investors in recent months – Greek debt woes, a general slowing of global economic growth, and a deepening fiscal crisis in Washington – are the same ones that loomed large this time last year. The market reaction to these problems, moreover, has been strikingly similar: Investors have reduced their exposure to equities and other assets perceived as risky, and fled to traditional safe havens, including low-yielding U.S. Treasury securities and German bunds. Equities and commodities have endured a stiff correction, Treasury bond yields fell below 3% before rebounding at quarter's end and the dollar has bounced off its lows.

The question on every investor's mind: Will this year's episode of market weakness and uncertainty end as positively as last year's, with growth reaccelerating and equity markets posting strong recoveries? We think the answer is “yes” and view declines as buying opportunities. Consequently, we are maintaining our bullish, pro-cyclical position that tilts toward equities and away from fixed-income securities. We continue to emphasize high-yield bonds over investment-grade debt, with an eye toward increasing bullish leanings if equity valuations become more compelling.

The U.S. Economy: Slip, Blip or Double-Dip?

There is no disputing that economic growth has slowed in the U.S. and elsewhere. The issue is whether this deceleration is a prelude to a more serious decline. We would argue that this is another economic soft patch that will eventually resolve itself. However, some of the drivers behind the weakening trend are more fundamental and longer-lasting than others. The pullback in manufacturing activity – the sharpest since the recovery began – is not expected to last long. A large part of the weakness was the result of disrupted supply chains caused by February’s earthquake and tsunami disaster in Japan, as shown in Exhibit 1.

The auto and technology industries were particularly affected. By the end of April, however, production lines in Japan were resuming and a snap-back in that country’s output is expected in the months immediately ahead.

Within the U.S., we should see a strong contribution to growth coming from auto manufacturers during the third quarter as car assemblies rebound from depressed second-quarter levels.

Most economists are looking for a rebound in U.S. gross domestic product (GDP) of close to 3.25% during the second half of the year, versus the 2.25% growth estimated for the first half.

Exhibit 1: Japan’s Output Collapse is a Disruptive Force

On the negative side, there are still a variety of formidable headwinds that will likely impede overall growth and job
creation. Higher energy prices, for example, have weighed on household incomes and confidence since the onset of the Arab Spring back in January and February. Although crude oil prices have fallen sharply in recent weeks, reacting to the deceleration in global growth, they remain elevated compared to a year ago. Since the war in Libya continues to drag on, and tensions remain high throughout the Middle East and North Africa, there is always the chance of another geopolitical event that could drive oil prices to recession-causing levels. Fortunately, Saudi Arabia and the other big oil-producing states remain calm politically and are in a position to supply enough oil to keep prices within reasonable bounds.

Housing is another weak spot that refuses to recover significantly. Contrary to the historical V-shaped pattern illustrated in Exhibit 2, new-home construction in this cycle has failed to bounce back from its collapse. Whereas new-home construction was an important source of growth in jobs and incomes in previous U.S. expansions, housing starts and sales of new and existing homes have bounced stubbornly along the lows, providing little contribution to GDP growth.

Exhibit 2: The Housing Bust Impedes the Employment Rebound

From World War II through the mid-1980s, housing starts typically climbed 60% or more during the first year of recovery. Housing starts often doubled off the lows within two or three years. Between 1990 and 2007, cycles in housing were almost eradicated – the result of slowing population growth and household formation, as well as regulatory changes to housing financing that tempered the feast-or-famine nature of the construction cycle.

The ongoing weakness in home prices (shown in Exhibit 3) has raised concerns that household wealth will come under more pressure and short-circuit the improvement in consumer spending. To put a positive spin on this price weakness, it shows that the painful but necessary de-leveraging process in the U.S. continues apace. Banks have increased their sales of distressed properties, a necessary move toward recovery. Although the shadow inventory of distressed property (real estate still on banks’ balance sheets plus homes in the foreclosure process) remains near a cycle high, it appears to have peaked. Seriously delinquent mortgages (i.e., those 90 days or more past due plus those in foreclosure) have been falling steadily over the past year.

Exhibit 3: Home Prices are Still Falling

Nonetheless, it will take a few more years to work off this supply, keeping downward pressure on home prices and limiting new-home construction. This presents an opportunity for first-time buyers and others who are in the position to buy a home. Housing affordability has never been better – the median family income qualifies to buy a home that is nearly double the median price, as Exhibit 4 shows.

Exhibit 4: A Good Time to Buy a Home
Fiscal Fizzle, Money Muzzled

Another headwind that’s set to blow harder is fiscal policy. While spending at the federal level continues to run amok, leading to a deficit that hovers around 9% of GDP, the noose is tightening at the state and local levels. State revenues actually increased on a year-over-year basis, benefiting from higher taxes, fees levied and the modest cyclical recovery over the past two years in business activity. (Tax revenues at the local level remain under pressure, however, given this level of government’s dependence on property taxes.) Thanks to the improvement in the revenue base, along with steady reductions in state and local workforces, the fiscal conditions of the states are beginning to stabilize. The worst fear of investors – namely, a collapse of the municipal bond market – has not materialized. But pressures to reform spending on pensions, education and health care will remain intense for years to come.

At the federal level, the debate over the debt ceiling will likely become an obsession for investors as the August 2nd deadline nears. This deadline represents an opportunity to push government spending onto a more sustainable course, as was the case with passage of the continuing budget resolution in December 2010 and the belated approval of the 2011 budget in April. In view of the entrenched positions and the ideological divide between the parties, the negotiations will likely go down to the wire. Nonetheless, a compromise is the only logical outcome – a government shutdown or a technical default would be highly disruptive and politically damaging to one or both sides.

Thus far, House and Senate negotiators have found $1 trillion of savings through fiscal year 2020 upon which they can agree. Although this sounds like a huge savings, it really isn’t significant. The Congressional Budget Office is forecasting an $11 trillion cumulative deficit under current law over the fiscal year 2012-2021 period, with outlays totalling $45 trillion. The Republican leadership, influenced by the party’s powerful freshman class, is seeking a $3 trillion “down payment” in exchange for approving a debt ceiling increase amounting to an equal dollar amount. It is unlikely this will be achieved, but any resulting compromises will bring negotiators closer to reaching the goal. Anything less would cause the debt ceiling to be breached again in the heat of the Presidential elections – an unappetizing prospect for any incumbent.

Pressure is also building to reform the budget process in a way that will disallow new spending initiatives unless there is money to pay for them. The Gramm-Rudman-Hollings legislation in the late 1980s and the Omnibus Budget Reconciliation Act of 1990 may serve as templates. Spending caps and the sequestering of funds may not be optimal solutions, but they would be an improvement to the current lack of spending discipline.

Unfortunately, it will likely take another election cycle before a more comprehensive budget agreement is attempted. Most impartial political pundits expect that the Senate will have a Republican majority after the 2012 elections – 24 out of the 34 seats up for contention are currently held by Democrats at a time when anti-incumbent feelings are prevalent. The chances appear good that the House will remain in Republican hands, although the size of the majority could diminish. Even if President Obama were re-elected, there would be immense pressure to deal more forcefully with the country’s fiscal problems through tax and entitlement reform in the President’s second term. Believe it or not, there really is reason for hope and change.

Just as fiscal policy is moving away from extraordinary stimulus measures, so too is monetary policy. The end of the second round of quantitative easing (QE2), however, is not being mourned by many. On the contrary, the impact of the Fed’s unorthodox policy of expanding its balance sheet has been hotly debated. Measured from the end of August 2010, when Fed Governor Ben Bernanke announced the central bank’s intention to engage in another round of large-scale asset purchases, stock prices (as measured by the S&P 500) have climbed 25%, Treasury bond yields are modestly higher by about one-quarter percentage point, the trade-weighted value of the dollar is down a sharp 9% and the S&P/GSCI commodities spot price (the price that a commodity can be traded at a specified time and place) has jumped about 30%. It’s hard to say what role QE2 really played in all this. Although Chairman Bernanke likes to take credit for the pop in stock prices, his critics blame QE2 for the drop in the dollar and the surge in commodity prices. However, the quantitative easing effort appears to have failed in its most important goal: jump-starting economic growth.

In last October’s Quarterly Economic Review, SEI expressed scepticism that another round of QE would have the desired impact of (1) encouraging lending to businesses and households; (2) increasing the broadly-defined money supply; and (3) boosting economic growth. We pointed out in that report the two big problems that the Fed faced. The first was the collapse of the money multiplier (defined as the M2 money supply– a broad measure of money that includes currency, demand and savings deposits, retail money market funds and other readily available deposits – divided by the monetary base. The second problem was the equally stunning decline in the velocity of money (GDP divided by M2), or the number of times a dollar is spent in the economy over a year’s time. Exhibits 5 and 6 are updated versions of the two charts we presented.
Since the onset of QE2, the money multiplier has sustained another waterfall decline, indicating that banks continue to hoard reserves instead of creating loans. The 30% increase in the monetary base between November and May has translated into just a 2.4% gain in the M2 money supply – not much “buck for the bang.” On a more positive note, the velocity of money has been more stable in recent quarters, allowing nominal GDP to grow in line with the modest rise in the money supply.

Proponents of quantitative easing insist that the economy would be even weaker without the Fed’s continued activism. We think that is hard to prove, given the evidence. The fact is that the U.S. financial system remains burdened by impaired assets that will take time to work out. On the plus side, lending standards have eased and we are seeing growth in commercial and industrial loans for the first time since 2008. Mortgage and consumer loans continue to contract, however. It doesn’t help that banks continue to operate in a highly uncertain regulatory environment as arguments continue over capital requirements and government-mandated changes to banks’ business models.

In all, there’s no denying that the U.S. economy still appears fragile. The recent downward shift in growth has probably been exaggerated by such developments as the spike in oil prices and the tragedy in Japan. We look for a modest rebound in the months ahead. Nonetheless, the path to full recovery remains arduous. The deleveraging process continues to weigh on household spending and the need to rein in deficits has begun to affect the public sector in a more substantial way. Fiscal and monetary policy appears to have lost its potency as a positive economic force. While we think the extraordinary measures pursued by the government during the crisis period helped prevent an even deeper recession, we think the economy and the financial markets now would benefit from less government intervention.

Hope for Change

We tend to agree with Winston Churchill’s observation: “You can always count on America to do the right thing – after it exhausts all the other possibilities.” While it’s a point that many would debate, we think America may have finally reached the point where it starts doing the “right” things. It’s our contention that the U.S. is at the beginning of a profound shift toward actually dealing with such knotty problems as the unsustainable trend in public-employee pension and health-care benefits, the looming Medicare and Medicaid crises, overleveraged household finances, the housing overhang, and the budgetary boondoggles, such as ethanol subsidies, that drain national wealth through the political process. As we highlighted above, the states have already reached the point where they are being forced to make difficult choices. The federal government is finally moving in that direction too – kicking and screaming along the way. We believe, nonetheless, there is a growing conviction that throwing more debt at the problem will not improve the country’s economic performance or create jobs, even in the short run. The results of last November’s elections and the popularity of the Tea Party movement have emboldened the reformers.

Europe is also grappling with the need to rein in the cost of the welfare state. However, it has yet to exhaust all the other possibilities. As we write this report, the negotiations between Greece and the European Union over a new bailout package for Greece continues. With the passage of the latest austerity package by the Greek parliament, it’s likely that the funds will be paid out, staving off a default in July. The prospect of contagion is simply too great, with the finances of Portugal and Ireland still so shaky. While politicians play for time, however, investors are no longer under any illusions; the issue is not whether Greece will default, but when. In the past month, Greek two-year notes
briefly exceeded 30% while the benchmark ten-year bond still hovers near an impossibly high 17%.

Yet, Europe’s political elite does not dare speak openly of Greece’s insolvent state. In their hopes of keeping the eurozone intact, there is only talk of tiding the country over with more loans in exchange for more economic austerity and the privatization of state assets. Private investors, meanwhile, continue to shed their exposure to Greek assets. According to a recent report by Barclays Capital¹, more than 50% of Greece’s public debt is now held by official institutions, including European governments, the International Monetary Fund, the European Central Bank and the national central banks of the eurozone. This socialization of risk across the member states will only add to the irritation of those who will end up paying the bill for Greece’s eventual default, namely the taxpayers of Europe’s healthier core countries.

It’s still anyone’s guess when the endgame of default comes. We wonder how long the Greek people themselves will put up with unremitting austerity, but they would face a horrendous adjustment if they defaulted now and were cut off from aid. Until the government achieves a primary surplus (that is, revenues match expenditures before interest payments on the debt), a default is not in the country’s best interest. Exhibit 7 shows that Greece’s primary deficit was 5% of GDP in 2010. Even with the new round of austerity measures that will be put in place over the next three years, it will be difficult to achieve balance, as economic recession lowers expected revenues and forces additional spending for unemployment insurance.

On the other side of the divide, it is hard to gauge the patience of voters in the countries that are keeping Greece afloat. While the political elite prefer a more complete fiscal union, that preference extends down the social spectrum only so far. The rising popularity of nationalist and ultra-right parties, such as the True Finns in Finland, the Freedom Party in the Netherlands or the National Front in France, underscores the currently fragile state of European unity. Some of the recent decisions of Germany’s Merkel government – its abstention from the United Nations Security Council on imposing a no-fly zone on Libya, its abrupt about-face on nuclear power, and its aborted attempt to force private investors to accede to a restructuring of Greek debt – should be seen through the prism of the growing discontent of the German electorate.

The best-case scenario has Greece avoiding default for another year of two. By that time, there will be fewer private investors directly hurt by the event. Banks will have written down the debt or sold it off. More importantly, other countries with severe debt issues might have had enough time to improve their economic and financial prospects, although this may be an unrealistic assumption. The risk of contagion will stay high for the foreseeable future, in our opinion. Of course, even a default will not solve Greece’s competitive issues. A default on the debt and an exit from the euro could occur at the same time.

Given the problems facing the eurozone, we find the euro’s resilience surprising. In 2010, when the periphery debt problems first took centre stage, the euro tumbled below $1.20. At the current value of $1.43, the currency remains more than 20% above its purchasing power parity, according to the Organisation for Economic Co-operation and Development. This has not been a problem for the European core – exports have risen sharply over the past year, although some deceleration in growth appears to have taken hold in recent months. It does represent a major problem, however, for the uncompetitive countries on the periphery, since the currency straitjacket binding them stymies their ability to grow out of their debt problems. That said, it is evident from Exhibit 8 that the euro is reacting positively to the increasing interest-rate differential that exists between European and U.S. interest rates.

In the absence of a Greek meltdown or a financial accident among the weakest members, the needs of the European core will drive economic policy. We believe the European Central Bank will continue to cautiously raise interest rates over the next year in a desire to normalize monetary policy and short-circuit inflationary pressures. But the dangers of normalizing too fast are very real.

¹ Laurent Fransolet, “Greek Top 40 and the ‘voluntary’ question,” Barclays Capital, June 16, 2011
As interest rates rise, the difficulties of the peripheral countries will only grow worse. The euro’s appreciating trend against the dollar on the strength of a widening interest-rate differential could shift into reverse quite abruptly if the debt crisis spirals out of control.

**Exhibit 8: The Euro Acts Like There’s No Problem**

![Graph showing the appreciation trend of the euro against the dollar](source)

The euro’s appreciating trend against the dollar on the strength of a widening interest-rate differential could shift into reverse quite abruptly if the debt crisis spirals out of control.

**Emerging Markets: Mounting Challenges**

While much of the developed world battles slow growth, high unemployment rates and unsustainable fiscal trends, the big emerging markets of China, India and Brazil face an opposite set of challenges. Government economic policy is being tightened in these countries in order to slow inflation and prevent the creation of debt and real estate bubbles. China, for example, recently raised its required reserve ratios for the sixth time this year (as Exhibit 9 highlights), and many expect the government to keep pushing against inflationary pressures.

**Exhibit 9: China Takes a Hard Line**

![Graph showing reserve requirements and interest rates](source)

These moves appear to have had the desired effect of easing money growth, as seen in Exhibit 10. If previous relationships hold, and a deceleration in the inflation rate materializes, the world economy would benefit.

**Exhibit 10: Money Growth is Down. Will Inflation Follow?**

![Graph showing money growth and inflation rates](source)

The longstanding imbalances in the Chinese economy, however, remain highly concerning. For example, the country continues to strongly favour investment and exports over domestic consumption and social welfare. In addition, the financial system is terribly opaque; it’s unclear how much debt is on the books of local governments’ off-balance-sheet financing entities. Another bail-out of the banking system – a cyclical occurrence in this country – cannot be ruled out. Perhaps most importantly, there is the looming demographics problem that China will not be able to avoid. The One-Child policy, introduced in 1978, has come home to roost in the form of a severe shortage of females of marriageable age. This shortage, combined with the sharp decline in the fertility rate, is projected to lead to a collapse in China’s working-age population within two decades – by 2035, China will be older than Japan or Italy.

Unfortunately, China may be slow to react to the various economic and social pressures facing it over the next couple years, given the generational turnover in leadership that will be taking place. The recent crackdown on dissent (a reaction to the political ferment in the Middle East) and the resuscitation of the cult of Mao in some quarters of the country are signs that China could be on the cusp of an unexpected and little understood turn.

These misgivings are counterbalanced for the time being by China’s strong growth prospects as the population becomes more urbanized and prosperous. It’s probably a mistake to underestimate the country’s capacity to grow out of its debt and capital-misallocation problems. The social, demographic and political issues have not yet reached the point where investors need to rethink their basic assumptions about China. We are only looking at clouds on the horizon; hopefully, some of the darkness will dissipate.
In general, we are turning more cautious on emerging markets. We neutralized our previously bullish investment stance six months ago. The peak in the global growth cycle and the need to keep fighting inflation raises the odds of a harder landing than seems to be assumed by consensus thinking. In the equity market, valuations remain in a middling range relative to their historical average. However, they remain elevated when viewed relative to developed-market valuation metrics, as shown in Exhibit 11. If global growth continues to fade, a shift toward defence would include a tilt away from emerging market assets.

Exhibit 11: Developed Markets are Relatively Cheap

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Where We Stand

In our opinion, the good news currently balances out the bad news. On the good-news side, global growth appears resilient, although the rate of gain has eased in recent months in the face of higher energy costs and the disruption to global supply chains caused by the Japanese earthquake. Commodity prices have declined modestly, easing inflation fears. Corporate profits and cash flow remain buoyant, and household balance sheets in the U.S. continue to improve. In the developed world, monetary policy can still be described as expansionary, even as QE2 ends in the U.S. and a round of policy rate increases begins in Europe. Finally, stock market valuations remain neutral to attractive, for both developed and emerging markets.

Despite these positive developments, bad news has dominated investor thinking for the past few months, leading to a correction in the price of risky assets. Within a generally growing global economy, severe pockets of weakness can be found, including the U.S. housing market, the European periphery and the balance sheets of Chinese banks. In the emerging world, inflation remains a serious concern, and the danger exists that governments are forced take measures that slow their economies more than investors anticipate. Many countries around the world continue to grapple with the aftermath of the 2007-09 financial crisis, seeking ways to de-lever public and private balance sheets in the least disruptive manner possible.

In our active asset allocation positioning, SEI has held to an overweight in equities (emphasizing U.S. large stocks) versus investment-grade debt. This bet lost ground during the second quarter, but we’re confident stocks will rebound relative to bonds. We assume that the current deceleration in global growth will prove temporary. As business activity picks up, stock prices should respond positively relative to fixed-income assets. Exhibit 12 highlights the relative performance of the S&P 500 versus the Barclays Aggregate Bond Index, and tracks that performance against the year-over-year change in the Economic Cycle Research Institute (ECRI) Leading Index.

Assuming the continuation of an economic expansion, moderate improvement in the Leading Index along the lines of the 2004-2007 period appears reasonable. Under this scenario, we would look for a solid relative gain in stocks over bonds in the coming 12 months.

We also favour corporate debt over the sovereign variety, and U.S. high-yield bonds over investment-grade. This is consistent with our view that the corporate sectors in the U.S. and other developed economies are in very strong competitive positions. Productivity growth has been solid while unit labour costs remain subdued – a prescription for sustainably high profit margins and improvements in net income that comfortably exceed the growth in sales. Despite the surprisingly strong appreciation in Treasury bonds over this year, high-yield bonds have held up well. The widening of credit spreads should be contained, as long as default rates remain near current low levels. We anticipate that money will flow back into the high-yield sector as investor confidence improves – high-yield bonds remain an attractive asset class in a generally low-yielding world.

Regionally, we favour a tilt toward U.S. equity versus Europe and Japan. These are positions that have performed well when measured in local-currency terms. In Exhibit 13, we track the relative performance of the MSCI: US Total Return Index versus Japan and Europe (including the U.K.) since the trough in March 2009. Over this time, the U.S. Index has outperformed Europe by 15 percentage points in local currency terms and Japan by an eye-popping 60 percentage points. Adjusted for the dollar’s depreciation, however, the U.S. market has underperformed Europe by three percentage points and exceeded Japan by only 30 percentage points. On a year-to-date basis, outperformance of the MSCI: U.S. Index totals more than four percentage points in local-currency terms against Europe, but lags slightly in dollar-adjusted terms. Against Japan, the MSCI: U.S. total return amounts to 12 percentage points, both in local and dollar terms.
We are maintaining this position, owing to our view that the U.S. is the structurally sounder market despite the country's debt burden. As we argued earlier in this report, we think America is getting closer to dealing more forcefully with its fiscal issues. Meanwhile, the U.S. economy continues to enjoy a higher long-term growth rate, a more flexible cost structure and a far better demographic profile than either Europe or Japan.
All figures in US Dollars.

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