

2010 Economic Outlook

No Double-Dipping in 2010, but Watch Out for 2011

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Summary

- The global repair process continues. The U.S. upturn appears to be proceeding at a pace somewhat faster than the consensus was expecting a few months ago, and is more vibrant than the recoveries seen to date in most other developed countries. Trade-oriented economies in the developing world continue to grow rapidly.
- The U.S. yield curve has steepened to near-record levels, indicating a very liquid monetary environment. The odds are high that economic activity will continue to accelerate as businesses replenish inventories that have been worked down to very low levels. This in turn should lead to increased levels of employment and consumer spending, setting in motion a virtuous economic growth cycle.
- We expect a sustained economic recovery in 2010, although there remain obvious areas of weakness — the household sector, small business, state and local governments and construction.
- Substantial economic slack and low labor costs should keep U.S. inflation in check in 2010 and beyond, although industrial commodity prices may benefit from inventory replenishment and a strong recovery in global trade. Inflation in other developed countries should remain subdued as well, although productivity has been poor compared to the U.S. Meanwhile, signs of an inflation uptick in China have already caused some monetary “leaning against the wind” in that country and will increase the pressure to revalue the yuan against the dollar.
- The U.S. Treasury yield curve is likely to remain unusually steep well into 2010. Some flattening of the curve might occur as the Fed begins to lift short-term interest rates in response to a subsiding unemployment rate. We suspect the Fed will proceed with a great deal of caution. High unemployment, low core inflation and pending fiscal policy restraint may even keep the federal funds rate in the 0% to 0.25% range the entire year. At the longer end of the maturity spectrum, bond yields may remain range-bound for an extended period.
- Dollar bearishness is widespread; however, the U.S. trade position has improved significantly as Europe and Japan endure a significant loss of competitiveness. Concerns over the sovereign debt of certain euro-zone members could result in a more substantial flight-to-quality trade into the greenback at some point in the coming year than has already occurred. Dollar weakness may persist longer-term, but it may not be as much of a one-way street as is commonly expected.
- U.S. corporations are especially well-positioned to record sharp improvements in profits in the quarters immediately ahead. This stems from higher productivity growth and the sharp reduction in costs achieved during the downturn compared to

other developed countries. This operating leverage should provide a good underpinning for the equity markets, at least in the first half of the year.

- We have a positive view toward equities as we enter the new year. In the latter part of the year, however, the poor fiscal position many countries face, and the global economy's questionable staying power in 2011, may create some volatility. We expect stock market multiples to fall this year, a consequence of earnings rising faster than stock prices. Higher-quality stocks/markets are expected to continue their recent improvements after lagging badly through much of 2009.
- Economic challenges are building as 2011 comes into view. Increasing tax burdens and the winding down of the Obama stimulus program could hamper the expansion more severely than generally expected. Higher costs, stemming from increased industry regulation and financial reform, also have the potential of impeding economic growth.
- The spike in gold prices reflects investors' unease with the deterioration in developed economies' fiscal positions, fear of inflation and a general lack of confidence in fiat currencies¹, especially the dollar.
- Since gold has little intrinsic value, it is the ultimate barometer of investor sentiment and cannot be judged against standard valuation metrics such as price/earnings (P/E) ratios or discounted cash flows. Although still well below the 1980 peak, the real price of gold appears elevated in relation to the historical record of the past 750 years. A rebound in the dollar could elicit a sharp gold-price correction.

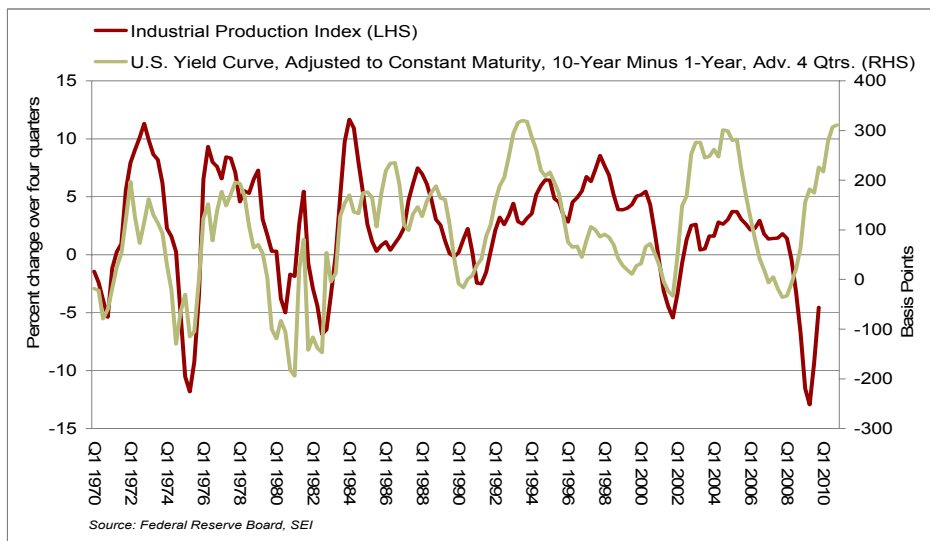
¹ Fiat currencies are those issued by governments and declared to be of value despite not being backed by gold, silver or another item of value. The U.S. dollar for example, is backed by the full faith and credit of the U.S. government, not by a commodity for which it can be exchanged.

If you Google the phrase “double-dip recessions” you will get 577,000 hits. Key in the phrase “double-dipping chips” and you will get 603,000 hits. Yes, at this time of year, when economists are thinking about the outlook for 2010 and American football enthusiasts are putting out the guacamole or Velveeta Cheese Spread at their Super Bowl parties, the double dip is a pressing concern.

In our opinion, the partygoers probably have a more legitimate worry than the economists. The global economy may be advancing by fits and starts, but we see little chance that it will sink back into recession in 2010. By contrast, the panelists surveyed by Consensus Economics, Inc, in December 2009 assign an almost 20% chance of at least one negative quarter in U.S. gross domestic product (GDP) this year. Granted, the outlook for 2011 appears far more challenging. The removal of monetary and fiscal stimuli is an issue that is looming larger on the horizon. But, in the near term, the cyclical improvement in economic activity appears well-established and is likely to show surprising growth over the next couple of quarters as economies normalize.

Our confidence that economic output will continue to improve in the months ahead is partly predicated on the current shape of the yield curve. The term structure of interest rates has proven to be one of the best leading indicators of future business activity, across both time and countries. In Exhibit 1, we show the yield spread between the U.S. 10-year Treasury bond and the one-year maturity versus the year-over-year change in the Industrial Production Index (IPI). The yield curve is advanced four quarters in order to highlight its predictive abilities. For example, the yield curve averaged more than 300 basis points (i.e. three percentage points) in the final quarter of 2009. This data point, however, is aligned with the projected fourth quarter of 2010 as the yield curve is a leading indicator. A wider yield spread gives banks better liquidity as they can borrow at short-term rates and lend at long-term rates. Increased lending helps businesses finance production. These relationship can be seen when looking backwards in time, with the prior year’s yield spread superimposed over the current year’s industrial production.

Exhibit 1: Industrial Production Looks Promising for 2010



As the yield curve steepens (i.e. the spread between the 10-year and the one-year Treasury widens), it will be more likely that production will increase over the following year. As the yield curve narrows, or inverts (i.e. when the 10-year yield falls below that of the one-year), the odds increase that production will log slower growth or an outright decline.

The yield curve has predicted every U.S. recession since 1950 with only one “false positive,” the 1966-67 slowdown; even that period, though, saw the 12-month change in the IPI slow from a 12.5% peak in October 1965 to a near-zero reading by July 1967. More recently, the yield curve attained its maximum steepness in the third quarter of 2003 (foreshadowing the deceleration in the IPI the following year) and inverted in the first quarter of 2006, seven quarters prior to the official start of the recession. While the yield curve won’t predict the magnitude of growth a year into the future, it provides a good guide to production accelerations and slowdowns.

We believe that the pace of economic improvement will quicken through the year. The steep yield curve has returned the banking system to profitability and strengthened balance sheets. We look for banks to step up their lending, albeit in a more responsible fashion, to businesses and consumers in the months ahead, now that the system has re-liquefied. This, in turn, will pave the way for gains in durables consumption, inventories and capital spending — the building blocks for a sustainable recovery.

With the exception of Japan, which continues to be mired in a structural deflation, yield curves for the other developed countries are configured in the same way. The evidence suggests that the predictive relationship of the yield curve to output is just as robust in Canada, the United Kingdom, and Germany as it is in the U.S.² Synchronized recession should be followed by synchronized recovery in 2010.

Exhibit 2 on the following page contrasts the Leading Indicators Index of the OECD members³ with that of the BRIC (Brazil, Russia, India and China) countries. These indexes are trend-adjusted to better show cyclical swings over time.

Although the BRIC countries have enjoyed faster secular growth and have led the way out of recession during the past several months, the trajectory of the recovery in developed countries’ leading indicators of growth appears to be on par with that of China and Russia, and stronger than that of Brazil and India. In general, cyclical turns in leading economic indicators precede turns in the economy by about six months. Exhibit 3 on the following page tracks the U.S. Leading Economic Index⁴ (LEI), advanced two quarters into the future, against the four-quarter change in real GDP. (An indicator similar to the relationship between yield spreads and industrial production highlighted in Exhibit 1.)

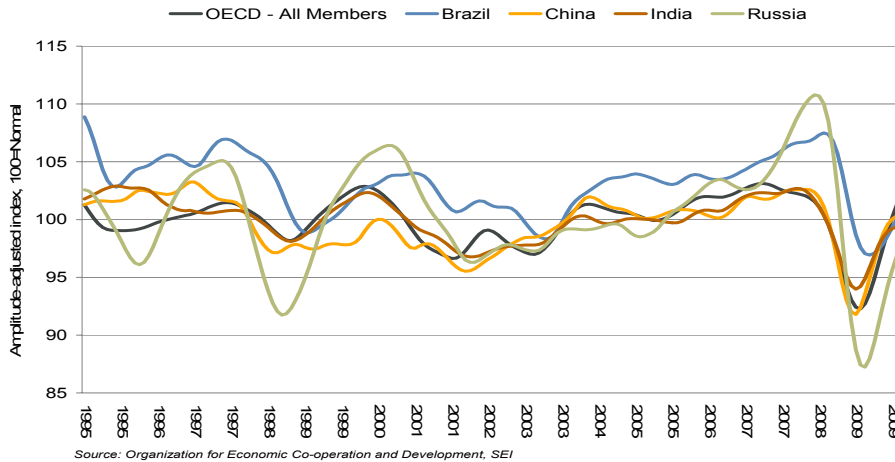
² Estrella, Arturo and Frederic S. Mishkin (1997) “The predictive power of the term structure of interest rates in Europe and the United States: Implications for the European central bank.” *European Economic Review* 41:1375-1401

³ The 30 member countries of OECD are: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

⁴ The Leading Economic Index, compiled by the Conference Board (a consulting firm), seeks to project the future direction of economic activity. A rising index is a positive signal.

The relationship has been very strong over the years, even providing some indication of the magnitude of the change in GDP — with the glaring exception of the past recession. If the relationship reasserts itself, the advance in the LEI augurs a much sharper recovery in business activity than most are currently willing to predict.

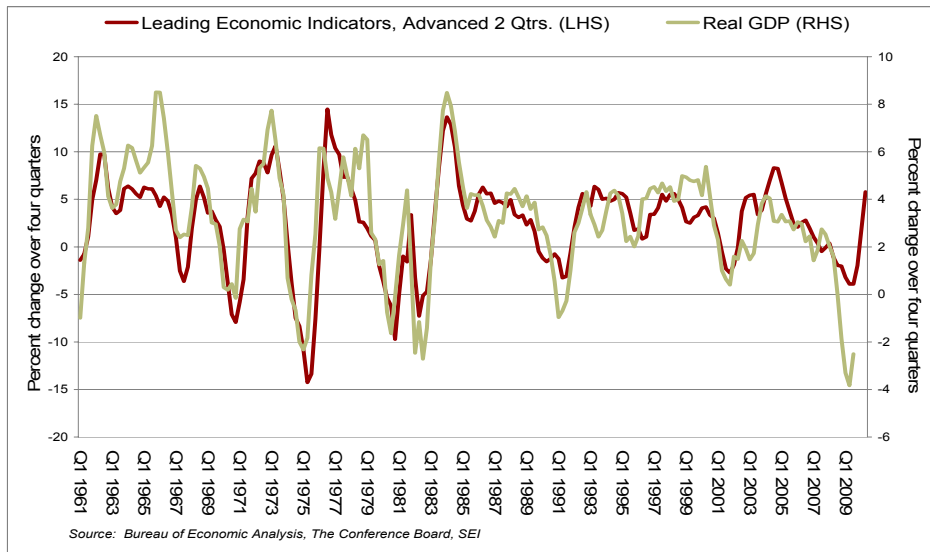
Exhibit 2: Leading Economic Indicators for OECD Member Nations*



Source: Organization for Economic Co-operation and Development, SEI

* Amplitude adjustment is designed to highlight cyclical fluctuations in economic activity against its long-term potential level. This makes it easier to judge the strength of a cyclical swing versus previous cycles, as well as against the cycles of other countries with different long-term growth rates. There are four cyclical phases: Expansion (above 100 and rising); downturn (above 100 and falling); slowdown (below 100 and falling); and recovery (below 100 and rising).

Exhibit 3: A Sharper Recovery on the Horizon?



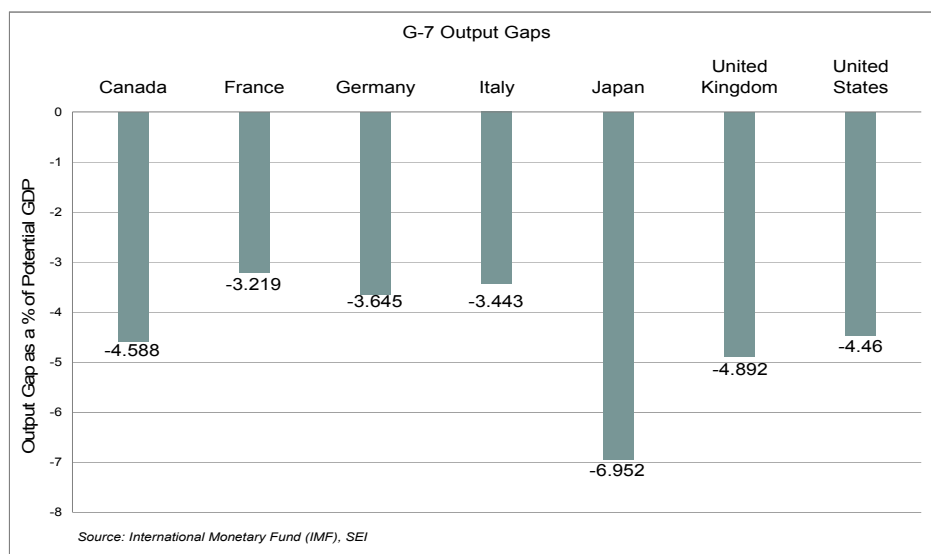
Source: Bureau of Economic Analysis, The Conference Board, SEI

Inflation: A Worry Not Just for Another Day but for Another Year

The harshest global recession since the 1930s pushed worldwide consumer price inflation to just about a 1% rate over the 12 months ended July 2009, according to the International Monetary Fund. One year previously, the global Consumer Price Index was advancing at a 7% clip, driven by the soaring price of oil and other commodities. As the world economy recovers, commodities are again running to the upside, and there is growing concern that inflation is beginning to accelerate. These worries have been fanned by the ballooning fiscal deficits of the developed countries and the extraordinary monetary stimuli put in place during the previous two years.

We have argued in previous Economic Outlooks that inflation is unlikely to be an issue for a long time, at least in the major developed economies. That continues to be our position. In our opinion, there is simply too much excess capacity and unemployment for serious price inflation to take hold. Exhibit 4 examines the output gap (i.e. the difference between actual and potential GDP) across the G-7 developed countries, as measured by the International Monetary Fund. With the exception of Germany, the gap in each of these countries is the highest since at least the 1970s. Not surprisingly, Japan has the biggest gap, following two decades of recession and sluggish growth, amounting to almost 7% of GDP. It explains why outright deflation remains a serious issue for that country.

Exhibit 4: Output Gap Suggests Little Inflation for G-7 Countries

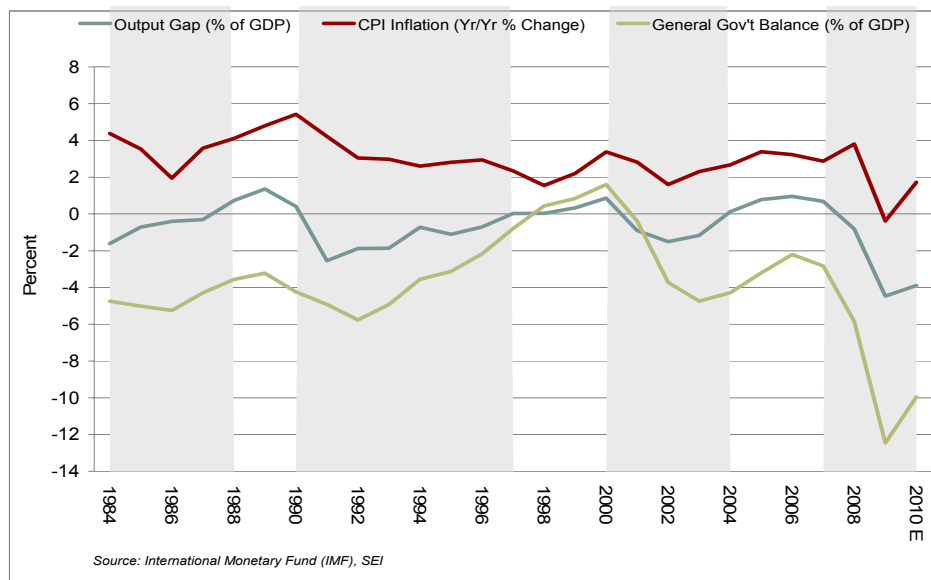


In the United States, the lowest operating rate in post-World War II history and the highest unemployment rate since 1982 generated a 4.6% output gap in 2009. Exhibit 5 on the following page underscores the fact that negative output gaps — even those appreciably smaller than the current one — have been associated with a declining inflation rate. We've also included the general government budget balance (incorporating the federal, state and local levels) as a percentage of GDP in the chart to highlight the fact that big and/or worsening budget deficits do not often generate an inflationary response. Rather, government deficits are themselves an outgrowth of the weakness in economic activity, driven in part by the same pressures that serve to

depress inflation. Given the magnitude of the output gap, we think it likely that inflation will remain subdued well into expansion.

Although one can point to the 1970s as a time when output gaps and high inflation coexisted, we believe it to be a false comparison to today. The emergence of China and other low-cost global producers, wide-ranging industrial and labor-market deregulation and the deflationary impact of rapid technological change are factors that undercut the pricing power of business and labor. When one adds into this mix the disruption to financial markets that has weakened the transition of money growth into inflation, it is difficult to argue that core inflation will become a major problem. This is especially the case in the U.S., where unit labor costs have declined and the Employment Cost Index⁵ has sagged below 2% in nominal terms. Unit labor costs on a year-over-year basis are still increasing in other developed economies (3.6% in the Euro-zone, 4.3% in the U.K and 2.5% in Canada, as of the third quarter of 2009), but the need to maintain competitiveness will force these countries to bring costs into line.

Exhibit 5: Negative Output Trends in U.S. Accompany Declining Inflation



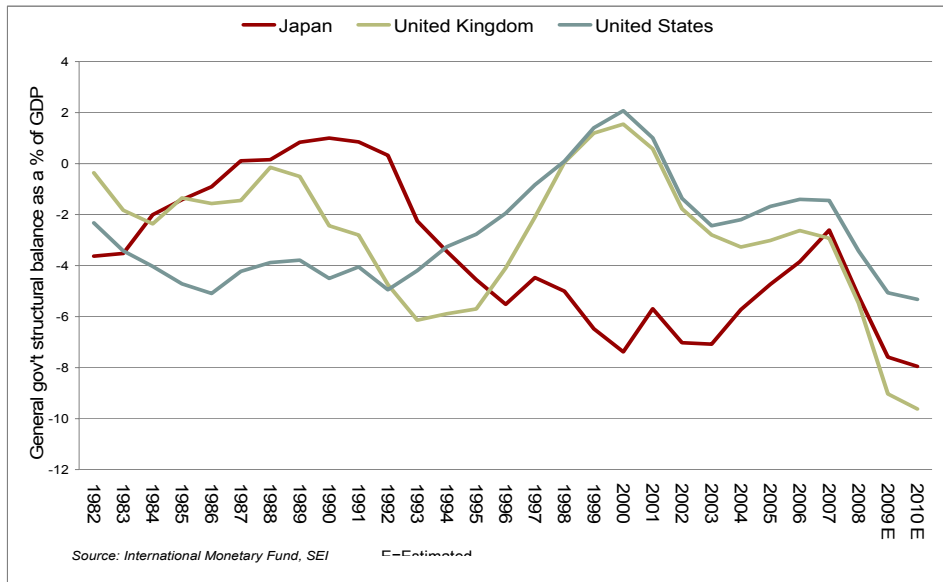
If an inflation problem is about to emerge anywhere, it will likely be in China, where inflation tends to be far more volatile owing to a greater dependency on food and other commodities relative to services. Fast economic growth and a boom in bank lending have already led to a strong recovery in asset prices, particularly in the property markets. We find it significant that the Bank of China has recently boosted reserve requirements for the first time since mid-2008, following several months of jawboning banks (with little success) to limit their lending. An emerging inflation problem in China will add to the pressure to allow its currency to revalue upward against the dollar.

⁵ The Employment Cost Index measures changes in wages, benefits, and bonuses. It is viewed as an indicator of inflation because wage increases are generally passed to consumers in the form of higher prices (inflation).

The Bill Comes Due in 2011

It is hard to deny that fiscal imbalances in many countries need to be addressed. In the U.S. the bill will come due in 2011. Although economic expansion will likely reduce unemployment and improve tax revenues on a cyclical basis, longer-lasting structural deficits still will be at or near record levels relative to GDP in the UK, Japan and the U.S., as seen in Exhibit 6 on the following page.

Exhibit 6: Rising Deficits



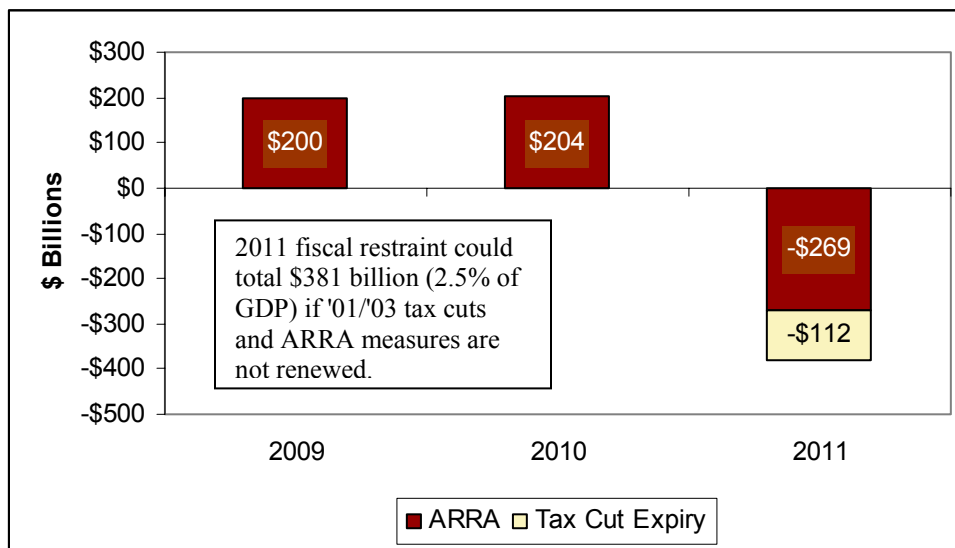
The governments in these countries need to walk a fine line, cutting the red ink at a pace that satisfies investors and the voting public but does not restrain economic growth too dramatically. If there is a danger of a double dip, it comes in the 2011-2012 period, as economic stimulus turns into substantial restraint. Policymakers should be cognizant of the dangers, since they have the lessons of 1936-37 in the U.S. (when the federal budget balance swung from a deficit of 3.8% of GDP to a surplus of 0.2%) and 1997 in Japan (when the government raised the consumption tax from 3% to 5%). In both cases, relatively strong expansions were short-circuited by tax increases and spending cuts.

For good or ill, a move to substantial fiscal restraint next year is already baked in the cake for the United States, as shown in Exhibit 7 on the following page. First, the expiration of the Bush tax cuts of 2001 and 2003 is expected to reduce the deficit by \$112 billion, or 0.7% of GDP in fiscal year 2011 (ending in September 2011), according to estimates made by the Congressional Budget Office. Second, the winding down of fiscal stimulus signed by President Obama last February (the American Recovery and Reinvestment Act of 2009) would result in an additional fiscal restraint of \$269 billion, or 1.8% of GDP. The combined effect of 2.5% of GDP is obviously substantial for an economy that is expected to grow only 4% or so in nominal terms.

The key point to remember: The increase in marginal tax rates and the winding down of the American Recovery and Reinvestment Act of 2009 (ARRA) stimulus do not depend on a new vote by Congress or a Presidential signature. On the contrary, Congress will need to actively agree on a new stimulus package in order to offset the pending

restraint. This could be hard to do in the politically charged atmosphere of a Congressional election year when vulnerable Democrats are under pressure to show fiscal responsibility. It's our sense that the electorate is skeptical about the efficacy of the stimuli and bail-outs that have occurred since early 2008. The tax rebates in the spring of 2008 did nothing to prevent recession. The ARRA stimulus did not prevent a rise in the unemployment rate well past the Administration's 8% expectation. And the bailout of the financial sector, while extremely successful in preventing systemic failure, has raised populist anger toward Wall Street to a pitch that hasn't been seen in a generation. Under these circumstances, it will be hard to pass another big stimulus package until another crisis hits.

Exhibit 7: Net Fiscal Stimulus versus Previous Year



The Fed Will Stay Easy

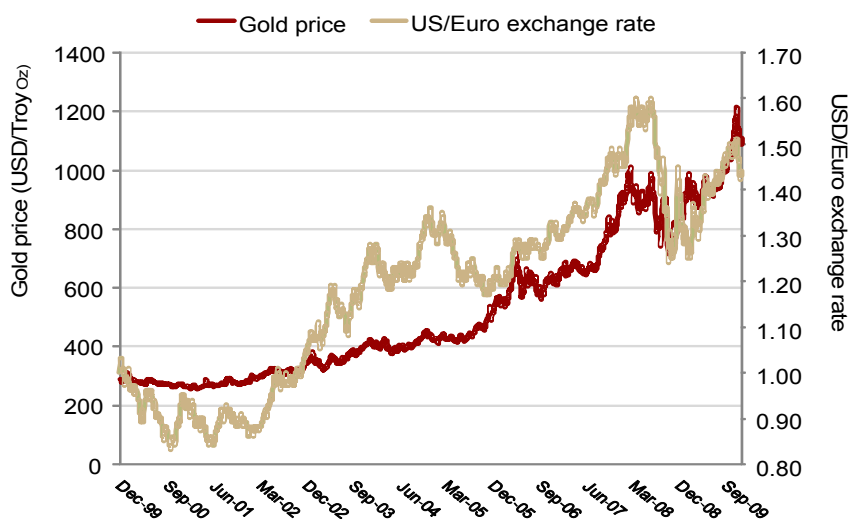
In the Economic Outlook for the third quarter, we suggested that the Fed would not be in any hurry to raise interest rates until the unemployment rate is clearly headed lower. We continue to believe that is the case, especially if fiscal policy moves toward restraint in the dramatic fashion suggested above. Fed Chairman Ben Bernanke, perhaps the foremost expert on the Great Depression, knows that the central bank made a critical mistake tightening monetary policy in 1936 and 1937, at a time when fiscal policy was lurching toward restraint. The concern of the Fed then was the same as it is now — whether and how quickly it should reduce the massive build-up of excess bank reserves on its balance sheet.

It's our position that the Federal Reserve will refrain from raising the federal funds rate well into 2010; we're beginning to think there may no be overt move at all. The yield curve should stay very steep, maintaining ample liquidity for the economy and supporting the financial markets. As investors begin to focus more sharply on 2011, however, stock and bond markets may become more volatile, a steep yield curve notwithstanding.

We expect most other developed countries to follow the Fed's lead in maintaining a relatively low interest-rate regime. Japan, for example, is likely to keep interest rates as low as possible in order to coax some weakening of the yen and to prevent a rise in interest expense on its mountain of government debt. The Bank of England, meanwhile, is facing a set of policy issues similar to the Fed. Indeed, fiscal policy has already tightened, with the country's value-added tax rising to 17.5% from 15% on January 1. In addition, a new top tax rate of 50% takes effect in April. Even the relatively hawkish European Central Bank may not raise interest rates too much in 2010. As already noted, the Eurozone appears to be recovering more slowly than the United States. The European Union also must contend with pockets of weakness among its member countries, specifically Greece, Spain, Portugal and Ireland.

However, a slow exit from quantitative easing and extremely low interest rates does carry some risks in the form of additional weakness in the value of the dollar. We do not believe that dollar weakness (or its inverse, gold-price strength, as depicted in Exhibit 8) is a one-way bet. We believe the U.S. is likely to grow at a faster clip than most other developed countries, the rebound in profits is likely to be stronger and unit labor costs lower, reinforcing the competitive advantage that a falling dollar provides U.S.-based manufacturers. Indeed, the U.S. current account deficit has narrowed considerably in recent years to 3% of GDP, its lowest level in a decade.

Exhibit 8: Gold and the U.S. Dollar



Source: Factset

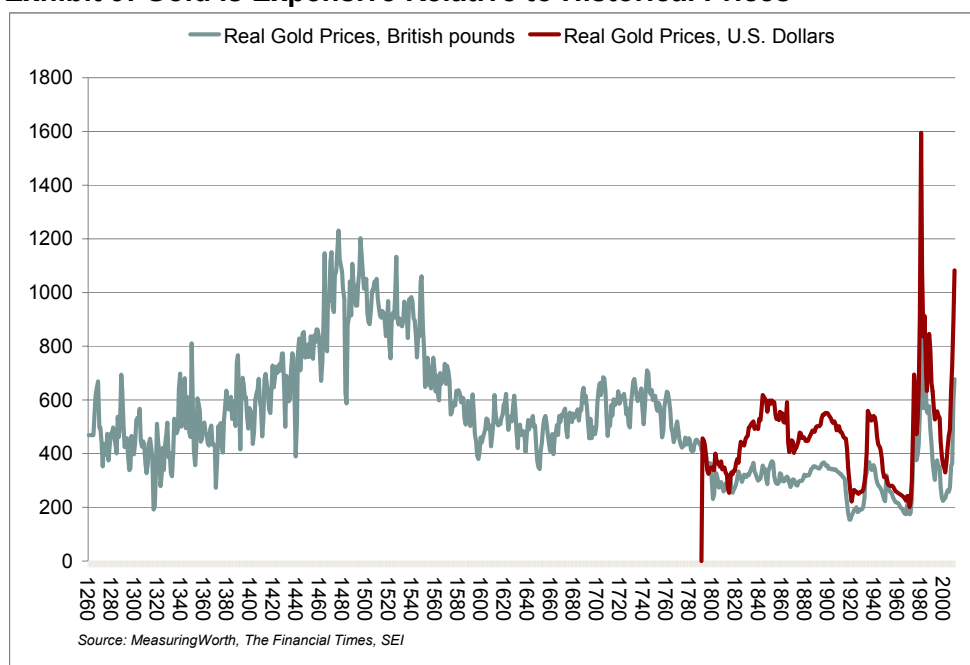
A Few Words About Gold

Gold is not an asset that easily fits into our allocation models. This is partly owing to the fact the yellow metal has little intrinsic value. It pays no dividend. It has no cash flow or earnings. It is of limited economic use. To put it simply, it is the ultimate barometer of investor sentiment. In addition to our inability to value gold as an investment, the metal empirically has not provided much of a positive real return over time, while periodically subjecting investors to extreme drawdowns.

If the object of investing is to buy low and sell high, this might be the time to sell. In our opinion, gold is beginning to take on aspects of a bubble. For the first time in 30 years, investment demand for gold exceeded jewelry demand in 2009 (the former doubling from the previous year to 1,820 metric tons and the latter falling 23% to a 21-year low of 1,687 tons according to London-based researcher GFMS Ltd. In our experience, it is usually a danger sign when investment-related factors trump traditional demand and supply fundamentals

Exhibit 9 charts the price of gold, adjusted for the cost of living, back 750 years — about as far as one can go in the historical record. In the chart, we compute the real price of gold in today's prices, both in British sterling (the currency does indeed go back that far in time) and in U.S. dollars (beginning in 1792). Obviously, a chart of this kind needs to be taken with a grain of salt, but it does strongly suggest that the real price of gold is relatively high at present compared to the historical record. In U.S. dollar terms, the price remains well below the spike of the inflationary 1970s, but is higher than past periods of unquestionable societal threat – the Civil War, the Great Depression and World War II. It is currently more than double the historical average. By comparison, the sterling price of gold appears less extended across the broad scope of history but is still 30% above the 750-year mean.

Exhibit 9: Gold is Expensive Relative to Historical Prices



We understand the rationale for holding gold—we simply question whether that rationale is sound. Although sovereign debt imbalances certainly exist, we think governments will be forced to address the issue. Indeed, as we point out above, a great deal of U.S. fiscal restraint is likely to begin within the next year. The related concern of debt monetization and high inflation also appears overwrought, especially in the developed world. Japan is instructive: heavy debt burdens can be deflationary, not inflationary. Finally, we do not believe that the value of the dollar is on the verge of collapse. On the contrary, when the financial crisis hit in 2008, the currency served as a safe haven. If

the value of the dollar rebounds owing to some geopolitical event or worries about the integrity of the European Union, the price of gold could be subject to a sharp correction.

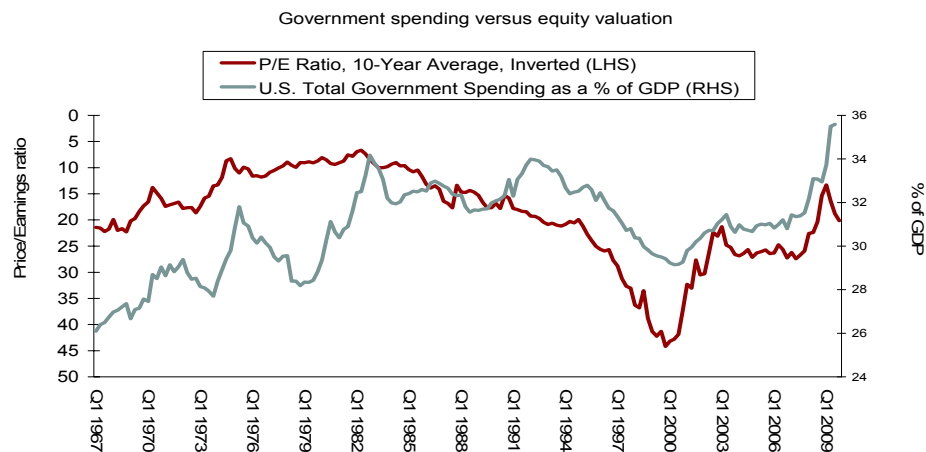
Market Implications

One year ago, equity and credit markets were in deep disarray and the world economy appeared to be in free fall. Since March 2009, however, financial markets have proceeded a very long way along the road of normalization. Stock markets have boomed, and credit spreads have narrowed sharply, even in the face of a generally hesitant lift out of recession. In 2010, we think the world's economies will come back to life. The major question is: how much of this year's economic recovery is already reflected in security prices? It's a pretty good bet that earnings multiples will decline, with profits rising faster than stock prices.

Economic recovery may turn out to be too vigorous in China and other leading emerging economies, which may necessitate additional monetary tightening, thereby dampening the remarkable performance of emerging-market stocks and bonds. At the other end of the spectrum, growth may continue to be rather slow in the developed world, especially in Europe and Japan. We anticipate that financial markets will be able to continue to grind higher in this environment, with a focus on higher-quality sectors of the market and momentum strategies that benefit from more consistent market trends.

The key concern in our view is the exit from governmental life support. A big increase in government spending was certainly the correct response as private-sector demand fell away in the latter part of 2008 and early 2009. Longer term, however, growth in government spending at the expense of the private sector reduces an economy's growth potential. It also impairs equity valuations, as seen in Exhibit 10.

Exhibit 10: Government Spending Can Take a Toll



Source: S&P, Bureau of Economic Analysis, Prof. Robert Shiller, SEI

This chart tracks total U.S. government spending as a percentage of GDP versus the long-term price/earnings (P/E) ratio of the S&P 500. The P/E ratio is inverted to better illustrate the relationship that exists over time. As government spending increases relative to the economy's size, market valuations tend to decline, as was the case between 1967 and 1982 and again from 2000 to the present. The relative size of government spending is not the only factor affecting valuations, but it underscores the

fact that it is the private sector that creates wealth; the government redistributes it. History shows that economic growth and equity valuations suffer when too much wealth is redistributed or when it gets redistributed in the wrong way. That said, the exit strategy from our current fiscal predicament could provoke the next slowdown/recession.

Substantially increased fiscal restraint in 2011 and continued low inflation should limit the upward pressure on bond yields and keep short-term interest rates low. We continue to see opportunities in credit, although the potential for appreciation is far less than it was last year. Although the consensus view on Treasury bonds is bearish, we would argue that low inflation and an exceedingly slow exit from monetary easing will offset the pressures of heavy debt issuance to a large extent. We expect an extended period of range-bound trading.

In sum, we continue to be optimistic about equities and credit, recognizing that the appreciation potential in the year ahead is likely to be considerably less compared to the recovery of the past year. The consensus view maintains that this positive performance will be front-loaded in the first half of the year. It's a reasonable view to hold in view of the currently positive economic backdrop. However, there are significant challenges ahead and it's unclear whether investors have appropriately accounted for them.

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