

2010 Themes: Hoping for Less Excitement

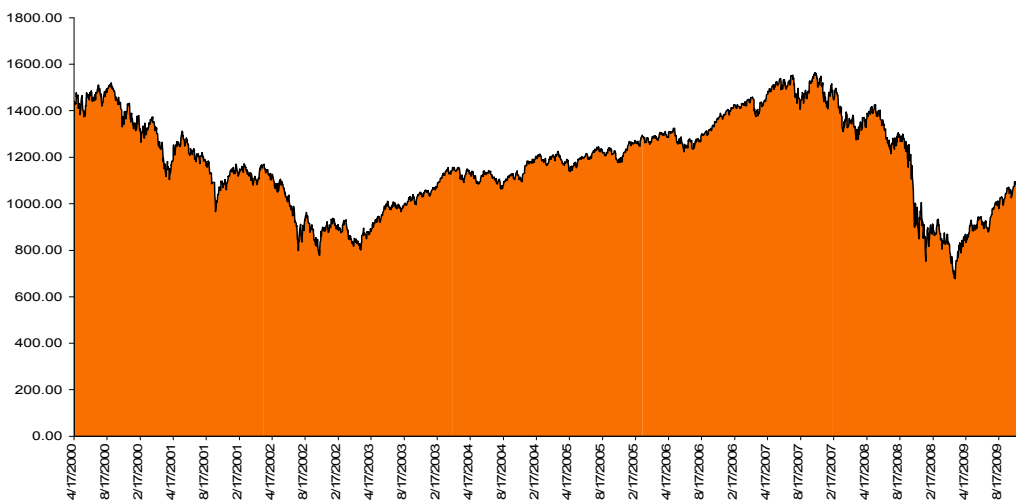
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SEI Global Fixed Income Management manages fixed-income strategies for SEI's Managed Account Program (MAP) and Integrated Managed Account Program (IMAP).

The first quarter of 2009 was driven by faltering equity markets and plummeting fixed-income prices. Then, as has happened in the past, an impressive snapback occurred that caught many investors off-guard on the sidelines holding large cash positions. This led to a rush into risky assets of all types, and for those who were able to stomach the volatility, the ending was euphoric.

As shown in Exhibit 1, the S&P 500 Index, a broad measure of equity markets, lost 47% from 1277.58 reached on September 2, 2008 (just before the collapse of Lehman Brothers) to its low of 676.53 reached on March 9, 2009. In the next 60 days following this low, the index roared back 37% to 929.23 on May 8; in the 261 days from March 9 to the recent high of 1110.63 on November 25, the index returned 64%. The index was up over 23% for 2009.

Exhibit 1: S&P 500 Index, April 2000 – December 2009

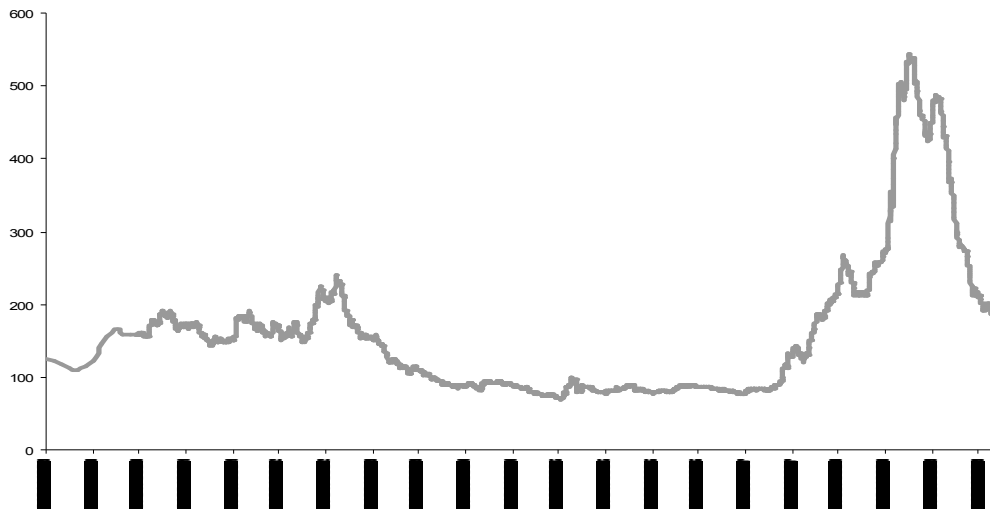


Sources: SEI, Bloomberg

Now let's look at the Barclays Capital Aggregate Index, proxy for the fixed-income markets. For the year, the index was up 5.96%—not as explosive but not too terrible.

Of course, this number doesn't accurately tell the whole story. The end result is respectable, and if you were asleep through the entire period, when you woke up you would think nothing out of the ordinary happened. However, the performance for various sectors tells a slightly different story. Looking at several components of the Barclays Capital Aggregate Index, corporate bonds returned 18.68%, commercial mortgage-backed securities gained 28.45%, U.S. mortgage-backed securities gained 5.89% and Treasuries declined 3.57%. This mix of sectors and returns helps paint a better picture of the volatility and movements that occurred in the fixed-income markets last year. Exhibit 2 shows the dramatic widening and eventual narrowing that option-adjusted spreads experienced during the latter half of the decade.

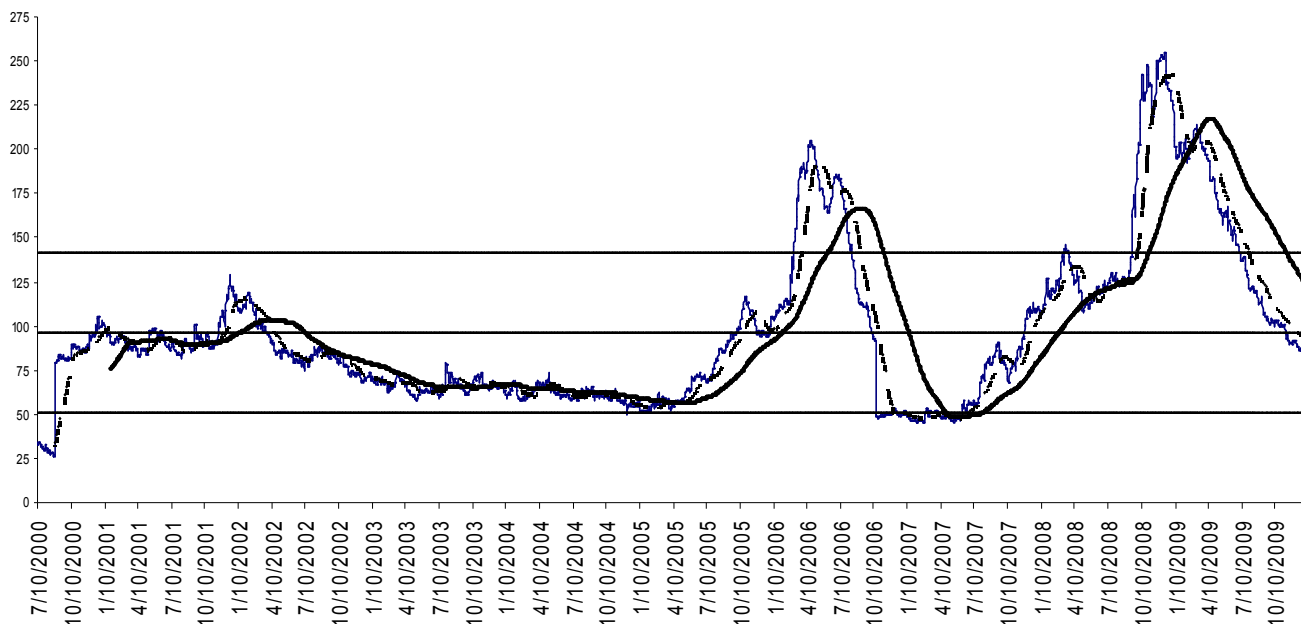
Exhibit 2: Option-Adjusted Spreads for the Barclays Capital Credit Index, August 1999 – November 2009



Source: Barclays

Now that 2009 is behind us, the full focus is on 2010 and potential developments. We believe several themes will be at the forefront in the year to come. First, fixed-income investors will be focused on the potential for economic growth. Exhibit 3 on the following page shows that sentiment continues to show signs of improvement.

Exhibit 3: Fixed-Income Sentiment, July 2000 – December 2009



Sources: SEI, Bloomberg. Fine line shows the Fixed Income Sentiment Index. Bold line denotes the 200-day moving average, while the dashed line denotes 50-day moving average.

This improvement came fast, and such a large move warrants caution. The markets and the economy were heavily tested over the past couple of years. In order for growth in the financial markets to continue, there needs to be continued signs of a sustainable recovery in the economy. Although the pace of growth can be debated, the bottom line is we need to see growth.

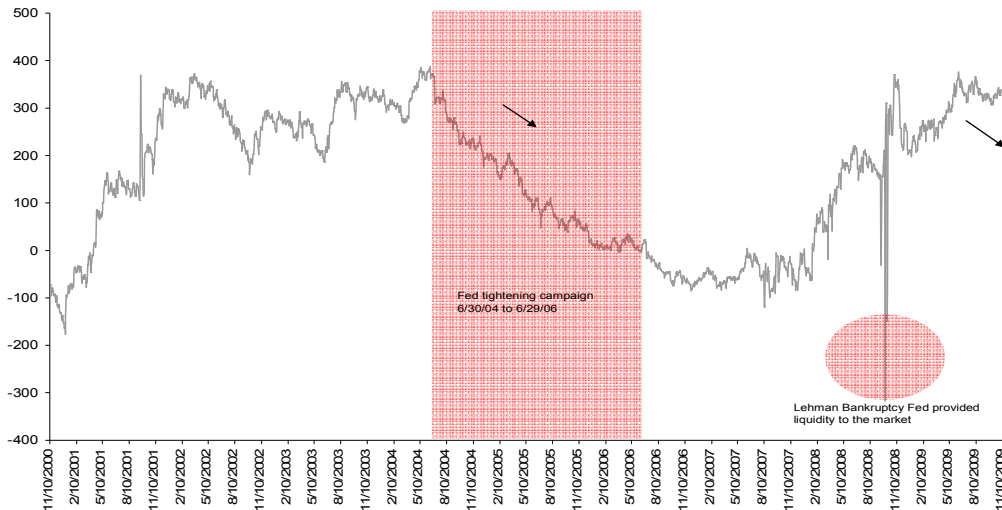
Rates: Higher, Steeper - and Eventually Flatter

We expect rates to move modestly higher in 2010, supported by concerns around supply as well as fiscal and monetary policy. In recent quarters, the weak economy supported Treasury prices and enabled the Fed to hold monetary policy at the current unprecedented low rate. The exceptionally low interest-rate environment anchored money market rates and the front end of the yield curve. Looking ahead, the support for the Treasury market should fade as we start to see continued signs of improvement.

While we have not yet seen a sustained move higher, the move is unlikely to resemble a straight line. As Exhibit 4 on the following page shows, cracks have formed, but there has not been enough force to break the ceiling. The curve is likely to remain steep until evidence suggests that the Fed will start unwinding its stimulus programs and tighten its monetary policy, which should slowly start to emerge as we move through 2010. Once this occurs, we expect the curve to start flattening, led by the front end, in anticipation of higher overnight rates. This goes against the view that in a recovery you will have inflationary pressures creating a steeper curve led by the long end. A similar move to the flattening bias occurred when the Federal Open Market Committee (FOMC) started removing accommodative policies at its meeting on June 30, 2004. The Committee tightened 17 times, raising the federal funds

rate 425 basis points from 1% to 5.25%. We do not believe rates will move in an identical fashion; however, when the Fed begins to remove its current accommodative stance, the curve will react swiftly.

Exhibit 4: Spread between the Federal Funds Open and Ten-Year Treasury, November 2000 – November 2009



Sources: SEI, Bloomberg

Our longer-term view is that the Treasury curve will regain its steepening trend once we see sustained growth within the economy and inflation becomes a factor. In addition, it's uncertain to what extent foreign investors will continue to demand U.S. debt. We have seen a modest decrease in interest from global investors over the third and fourth quarters of 2009. China and Japan remain the largest foreign holders of U.S. Treasuries through October 2009. The Chinese Premier has repeatedly expressed concern around Chinese investment in U.S. Treasuries. It is easy to understand why there is concern from global investors due to the ballooning U.S. deficit and weak dollar. As mentioned earlier, these are our concerns as well. The government needs to rein in its spending to help the deficit, but too much restraint will hinder growth within the U.S. as well as the global economy. It is one of many Catch-22 scenarios that require close monitoring.

Spreads: A Slow Grind

Spread products have outperformed expectations. High-yield bonds, represented by the Barclays Capital U.S. Corporate High Yield Index, led the charge, returning 53.18% year to date through November. Whether high yield or investment grade, spreads moved tighter at a grinding pace after their massive initial moves. Assuming that there are no major hiccups or changes in monetary policy, corporate or economic landscape conditions, our assessment of fundamental and technical aspects indicates that conditions should remain favorable for investment-grade corporate debt. The slow grind is expected to continue through 2010, and corporate fundamentals support this trend.

Central banks across the globe lowered interest rates to unprecedented levels, causing investors to search for yield. We expect to see a continuation of this status early into 2010, but at a more moderate pace. The search for yield has supported the robust new-issue calendar, adding to our positive view. Financials will continue to provide varying opportunities, as this sector looks to provide additional value on a spread basis versus Treasuries. Although event risk or a systemic move wider is not expected in 2010, we know that this sector is susceptible to these risks. For this reason, we remain cautious in the near term and look to underweight the Financials sector, especially weaker regions of the euro zone such as Italy, Greece and Ireland. Key drivers of our near-term underweight to the euro-zone regions are their huge budget deficits and severe recessions.

We expect stronger global growth to be driven by Asia and certain euro-zone regions, which falls in line with our view that large multinational companies should provide strong opportunities in 2010. Companies with a global scale should see support for their earnings, and we continue to focus on companies with a strong cash position. These companies should be able to either ride out any unforeseen downturns on the path to recovery or be able to take advantage of opportunities to build out their businesses.

Companies focused on one thing in 2009—rebuilding their balance sheets by extending the average maturity of their debt to reduce liquidity concerns. They also increased their cash positions, creating a strong base. The focus for 2010 will likely be on the shareholder at the expense of debt holders, which would be very similar to what we witnessed before and during the FOMC beginning to remove its accommodative policy back in 2004. At some point, we will start to see an increased level of merger-and-acquisition activity. Market conditions in the second half of 2009 have already provided a solid backdrop for acquisitions; in addition, companies have repaired their balance sheets. The ample cash held by these companies will likely be used for acquisitions to gain market position. Contrary to what we witnessed over the past two years, we should see more equity-friendly activity in the near term, such as an increase in dividends.

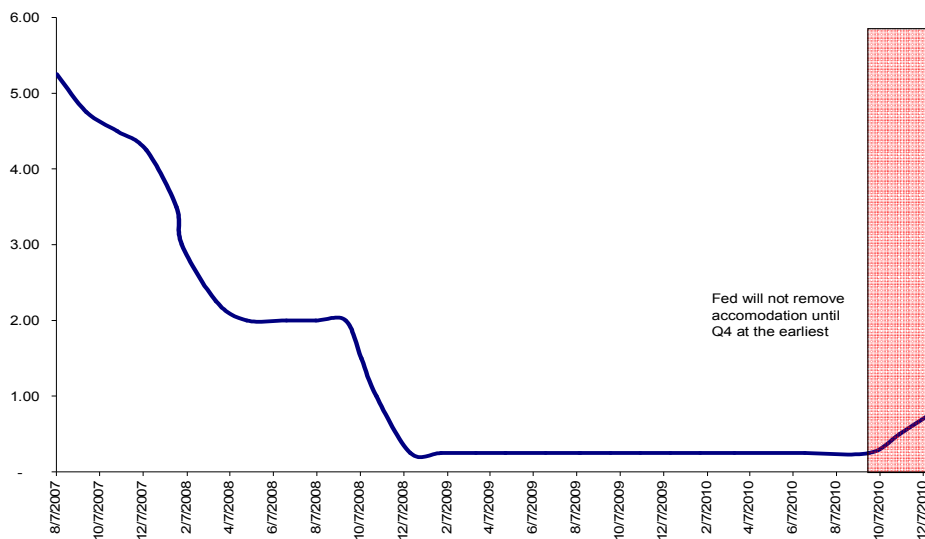
The Fed: The Inevitable March Higher

Although the Fed has been in crisis mode over the past two years, we are starting to see a gradual shift to a more forward-looking perspective. The FOMC will create a blueprint for gradually unwinding its current accommodative measures. We have seen early signs of this already, and our expectation is that the Fed will begin to re-craft its language within the first and second quarters of 2010 to provide a clearer picture on the timing of its exit strategy. We do not believe the removal of accommodative policy will happen all at once; rather, stimulus plans are likely to continue for months to come. The Committee's focus is currently geared toward improving the labor market, particularly the unemployment rate.

The Federal Reserve needs to balance the tug-of-war waging within the markets. Various issues will weigh heavily on the markets and the Fed's policy decisions. The Committee will need to wrestle with a weak labor market, inflation concerns and unwinding its quantitative easing programs. The Fed has made it clear that it is planning on leaving rates at these exceptionally low rates for a prolonged time (see Exhibit 5 below). This was reiterated through numerous Fed governors' speeches and policy statements.

Chairman Bernanke and other Fed governors seem confident that support can be removed without sparking inflation. However, Chairman Bernanke will need to provide additional direction on the timing of future interest-rate hikes, giving clear guidance to the market in order to avoid any surprises that may create undue volatility. We expect this type of rhetoric to pick up early in 2010.

Exhibit 5: Federal Funds Target Rate, August 2007 – December 2010 (projected)



Sources: SEI, Bloomberg

In our view, there is no rush for the Fed to start raising interest rates, as there is significantly more immediate downside risk if they move too early, particularly since inflation remains low. If stimulus is removed too quickly, it could be a recipe for deflation. Accommodative monetary policy does not create inflation, but excess cash in the system has the potential to create inflationary pressures. It can be said that the Fed's current policy is building a sizable monetary base. Instead of making credit available, banks are holding on to the cash to rebuild their balance sheets. If banks start lending and consumers start spending, this scenario could spark inflation. This, however, takes time. Although Fed members have commented that interest rates may remain "exceptionally low," this is a murky concept. From a historical perspective, 0.50%, 0.75% or even 1% is a historical low rate. The Committee could raise interest rates by 75 basis points and still stay true to its statement. Again, we feel that there isn't a rush for the FOMC to change its policy and start raising interest rates in the near term; on the other hand, we expect that when the decision comes for rates to march higher, the Committee will not waste any time.

Sovereign Debt: Under Pressure

The default of sovereign debt is a concern, and its potential will likely grow in 2010 and for some time to come. The question at hand is: can a country truly go bankrupt? Probably not—however, just the thought of insolvency can be detrimental to a portfolio, wreaking serious havoc in the global debt markets and freezing up liquidity and access to the credit markets.

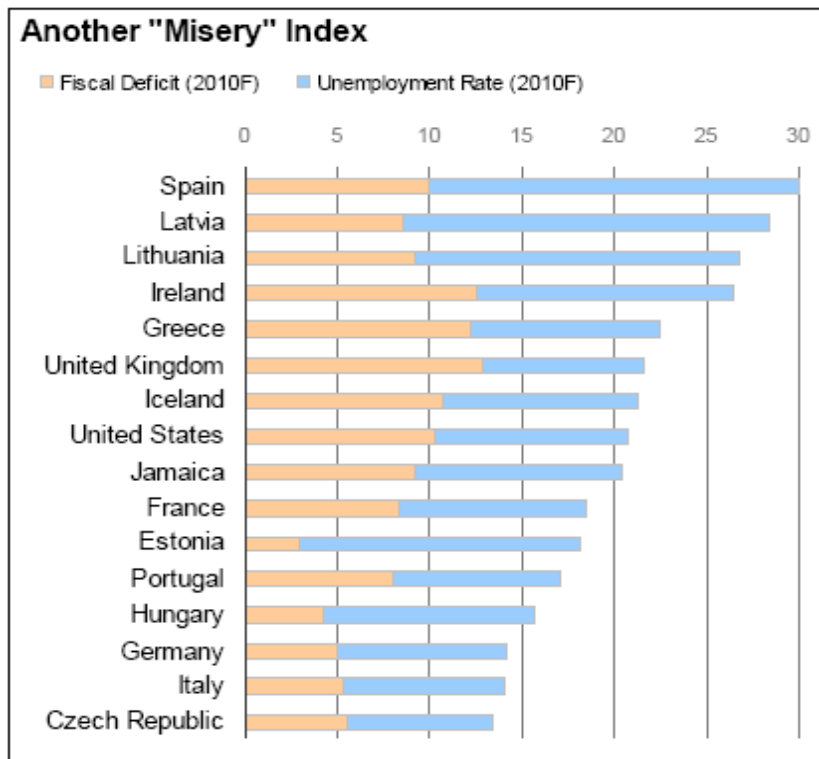
The increased probability of insolvency is two-fold, driven by both the global recession and weak labor markets, the severities of which vary throughout different regions. The unwinding of fiscal stimulus could also impact sovereign issuers, but its actual impact is difficult to pinpoint because the steps to unwind stimulus have not been laid out. Even if the process were defined, it would likely not be uniform across the various economies, making it difficult to quantify. Policy changes, specifically the determination to curb spending, could prevent further deterioration when and if changes materialize.

Just as banking and financial institutions felt pressures from their direct and indirect investments in the mortgage and structured markets, the same can be said for countries holding sovereign debt. Direct

and indirect exposure to ailing countries will put unbelievable pressure on their balance sheets and ignite the potential for ratings downgrades. Concerns around Dubai World’s debt were effectively pushed aside, but we are not so sure that faltering regions of the euro zone will be easily overlooked.

Exhibit 6 below depicts the increased risk and strain many countries face in upcoming quarters. While the original 1970s Misery Index used inflation and unemployment to gauge the health of a particular economy, the chart below replaces inflation with fiscal deficit—more fitting for the current environment. A higher number means a greater cause for concern. Granted, there are many pieces of information that collectively drive the economic landscape, but the combination of large deficits and high unemployment is worth monitoring. It is not likely that these indicators will improve anytime soon.

Exhibit 6: Fiscal Deficits and Unemployment Rates for Western Countries



Source: Moody’s Global Sovereign Data

Timing is everything. Globally, interest rates are on the rise, placing yet another pressure point on sovereign debt. The luxury of refinancing at ultra-low rates is slowly slipping away. Central banks around the world place money with sovereign issuers. If these issuers remain under pressure due to weak financial conditions, investors (including central banks) are likely to find another home for their cash. This environment will bode well for the U.S. dollar and the demand for gold.

Summary

The year 2010 will likely be a “rebuilding year,” as market participants continue to put the pieces back together. We should see a continued recovery within both the markets and the economy, albeit at a slower and choppier pace than most would like. The consumer needs to be a large growth driver, but concerns linger that consumers will not be able to fuel a sustainable recovery so long as the

unemployment rate stays high. Unfortunately, the recovery will likely be less robust than what is typical following a recession.

Treasuries will remain under pressure when interest rates move higher. Concerns around supply as well as fiscal and monetary policy will support this move higher. Treasury Inflation-Protected Securities (TIPS) are a slightly different story. Yields should move higher as well, but we feel these bonds will outperform nominal Treasuries. TIPS are currently attractive, with breakevens trading around 1.50% to 2.50%. Inflation is a longer-term concern, contingent on how well the Fed will be able to unwind its quantitative easing policy and start tightening interest rates.

Investors who lend money to Government Sponsored Enterprises (GSEs) received an early present. On December 24, the government lifted its bailout cap of \$400 billion to Fannie Mae and Freddie Mac. These funds were in place to keep the mortgage enterprises from failing. The government removed this cap to make clear that there was no uncertainty in its commitment to support these companies.

Our fixed-income outlook for 2010 is cautiously optimistic with hopes of less volatility. We will remain cautious and patient, looking for attractive opportunities to add to our portfolios. Many of our current views and trade ideas will carry into the New Year. Broadly speaking, we look to underweight the Treasury sector but continue to remain positive with regard to TIPS. We are positive toward investment-grade corporates, rotating into higher-quality names, and neutral on agency spreads. Diversification and risk management, as well as the ability to remain nimble, will play a very important role in 2010. The first of January not only brings us a New Year, but a new decade and the opportunity for new rewards.

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