

A Secular Bear Market in Treasuries—We're Prepared

By: Bill Lawrence, Managing Director and Portfolio Manager, SEI Global Fixed Income

- The bear market in bonds has begun, but we do not expect sudden, dramatic interest-rate changes.
- Our Funds and portfolios have underweight positions with regard to U.S. Treasuries.
- We are not overly concerned about the long-term implications for our holdings.

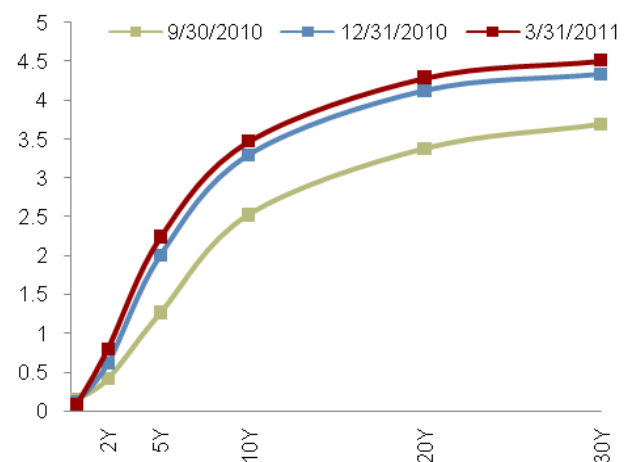
The single biggest question on fixed-income investors' minds is whether we stand at the cusp of a long-term rise in interest rates and a secular bear market for bonds. Unlike a cyclical bear market, which is characterized by shorter-term, temporary price declines, a secular bear market is a persistent long-term decline (in this case, think in terms of years). While we have little doubt that interest rates are headed higher from the recent historic lows, we expect the process to unfold over a fairly long period of time, with plenty of ebb and flow and relatively minor damage to the long end of the yield curve.

Interest Rates Are Likely to Rise—But Which Ones, and How High?

Interest rates have risen significantly since the start of the fourth quarter of 2010, as shown in Exhibit 1. This move has been driven by last fall's agreement to extend current tax rates, a steadily (if not spectacularly) improving economic outlook and higher inflation expectations.¹

There is no shortage of analysts or commentators who see frightening portents in this move. However, while we agree that interest rates are likely to head higher over time, SEI's outlook is more sanguine, as we believe that interest rates continue to be driven primarily, if not entirely, by U.S. economic fundamentals. For example, interest rates plummeted as the financial crisis and recession unfolded, despite widespread concern (which we shared) that massive new borrowing programs by the Treasury would push rates higher. Interest rates rose following the Federal

Exhibit 1: U.S. Treasury Yield Curve



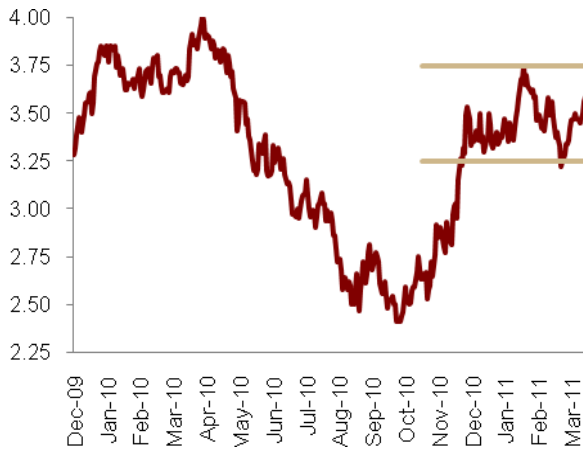
Reserve's announcement of QE2,² despite widespread expectations that the central bank's purchases would depress rates. Most recently, the flight-to-quality bids in U.S. Treasuries that followed political unrest in the Middle East and North Africa and the natural and nuclear disasters in Japan proved to be very short-lived, with yields quickly returning to levels that reflect prevailing growth and inflation expectations for the U.S. economy. Finally, as shown in Exhibit 2 on the following page, longer-term rates appear to have become range-bound following the high volatility of 2010.

If recent history is any guide, we would expect interest rates to continue to normalize alongside economic fundamentals.

¹ It is widely believed that Treasury yields have an expected inflation component and an expected real economic growth component that is driven by a variety of fundamental factors. When either of those rises (falls), it will put upward (downward) pressure on interest rates.

² "QE2" is the moniker given to the Federal Reserve Bank's second quantitative easing program.

Exhibit 2: Ten-Year U.S. Treasury Yield, 2009-2011



No Vigilantes on the Horizon

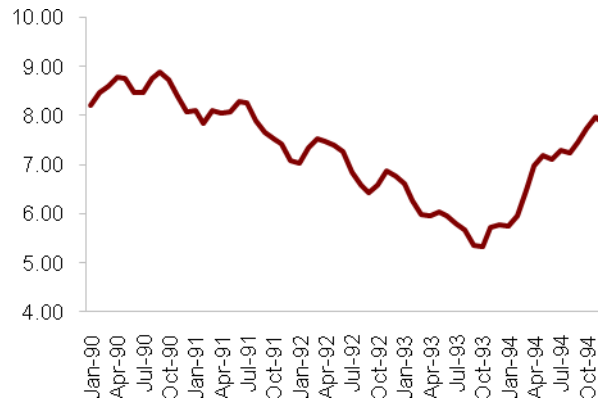
Some of the fears over a sudden and dramatic spike in interest rates are rooted in the bond market experiences of the 1990s, when it was believed that “bond vigilantes” would force interest rates sharply higher (through lower demand and outright short-selling or negative derivatives positioning) whenever they perceived U.S. monetary and/or fiscal policy as being too easy. This dynamic was such a powerful factor in the political landscape that one of President Clinton’s advisors, James Carville, reportedly quipped, “I used to think if there was reincarnation, I wanted to come back as the President or the Pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everyone.”³

There may have been some validity to Carville’s statement as Exhibit 3 shows. From the 1990-1991 recession until the end of 1993, the ten-year U.S. Treasury yield floated steadily downward at an average rate of 10 basis points per month. However, after the interest-rate cycle started to turn in late 1993, it rose back to the 8% level at the precipitous rate of almost 25 basis points per month. Global bond markets exhibited unexpectedly high levels of volatility in 1994. Orange County, California was one of the most memorable casualties of the period, declaring bankruptcy in December of that year, thanks to its County Treasurer’s wrong-way bets on interest rates.

³ John Greenwald et al., “Greenspan’s Rates of Wrath.” *Time*, November 28, 1994.
<<http://www.time.com/time/magazine/article/0,9171,981879,00.html>
Accessed on April 18, 2011.>

The 1994 cycle is similar to the current one in some important ways. Most notably, the financial system faces liquidity and capitalization challenges, and real-estate speculation was a precipitating factor.⁴

Exhibit 3: Ten-Year U.S. Treasury Yield, 1990-1994



However, there are also some critically important differences between 1994 and today that bond investors should consider. In that earlier episode, there was not a great deal of slack in the economy as measured by the output gap.⁵ Unemployment (and under-employment) was lower than it is today, and capacity utilization was much higher. This is relevant because an economy growing above its estimated potential has a positive output gap, which creates a risk of inflation as the overall demand for available resources such as labor and capital is high relative to their supply.

Thus, as economic activity began to accelerate, the Federal Reserve acted quickly to raise interest rates in order to prevent inflation.

Today, the output gap is significantly wider post-recession than it was in 1994, and unemployment remains stubbornly high, which should limit unexpected surprises in core inflation rates. This means that the Federal Reserve has a much wider margin of error in the current period. While we do not currently expect the Fed to embark on another round of quantitative easing, we believe that it is far more likely to err on the side of caution when it comes to initiating interest-rate hikes than it was in 1994. As a result, we expect the next period of rising interest rates to unfold over a rather long period of time. It will not be

⁴ In 1994, commercial real estate was at the epicenter of the bust. The Resolution Trust Company was formed by regulators in order to segregate and eventually liquidate troubled assets within the Savings and Loan industry.

⁵ The output gap is the difference between the actual output of an economy and its estimated potential output.

nearly as sudden or compressed as experienced in the 1994 rate cycle.

There is at least one interesting wrinkle to our outlook: If any economies resemble the U.S. circa 1994, it is developing ones, and many of them are currently trying to engineer soft landings by tightening monetary policy. Thus, if there is a bond market surprise in the next couple of years, it could well emanate from outside of the U.S., and we will continue to keep a close eye on fixed-income developments around the world.

Our Funds

While we do not agree with the most pessimistic scenarios circulating among bond-market commentators, we do believe that the natural direction for interest rates from here is up as economic fundamentals continue to improve. In the U.S. Fixed Income and Core Income Funds, the risks associated with this outlook are being managed in several ways, including strategic short-duration positioning, active tactical adjustments and relative shifts in sector allocations. We are not making interest-rate bets in the Funds; rather, they are positioned in a way that should provide greater consistency of returns with lower volatility.

Underlying manager activities have resulted in the implementation of a modestly short duration relative to benchmarks, and in tactical adjustments of the duration and yield-curve exposures with a curve-flattening bias. The Funds are significantly underweight nominal U.S. Treasuries (see Exhibit 4) as managers continue to see more attractive opportunities in other sectors, such as corporate and high-yield debt, agency- and non-agency-backed mortgage securities and bank loans.

Exhibit 4: U.S. Treasury Weights by Fund⁶

Fund	Benchmark	Weight (%)		Net (%)
		Fund	Benchmark	
SIMT U.S. Fixed Income	Barclay's Aggregate	16.32	32.86	(16.54)
SIMT Core Fixed Income	Barclay's Aggregate	12.80	32.86	(20.06)
SIIT Core Fixed Income	Barclay's Aggregate	18.81	32.86	(14.05)

⁶ As of March 31, 2011.

As a result, we believe that the Funds are well-positioned for what we expect will be a long and occasionally volatile interest-rate cycle. When interest rates do rise, current prices for most of the Funds' underlying holdings will fall. However, it is important to remember that (barring default) those holdings will continue to generate recurring cash flows that should help to offset declines in market values to at least some degree.

Our Portfolios

Investors often hold our fixed-income Funds in portfolios that also include exposure to equities. In all such portfolios, our Portfolio Strategies Group has taken proactive steps to prepare for current and expected market conditions. These preparations include making asset allocation changes so that our portfolios are:

- Underweight exposure to fixed income
- Overweight exposure to equities
- Underweight duration⁷
- Overweight high yield

These allocation tilts are designed to reduce the portfolios' overall interest-rate sensitivity.

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⁷ Duration is an estimate of the change in a security's or portfolio's value given a one percent change in interest rates. A higher duration means a more negative (positive) impact on market value from rising (falling) interest rates.