

Third Quarter 2011: Economic Outlook

Blood in the Streets: Time to Buy

By: James Solloway, CFA, Managing Director, Senior Portfolio Manager

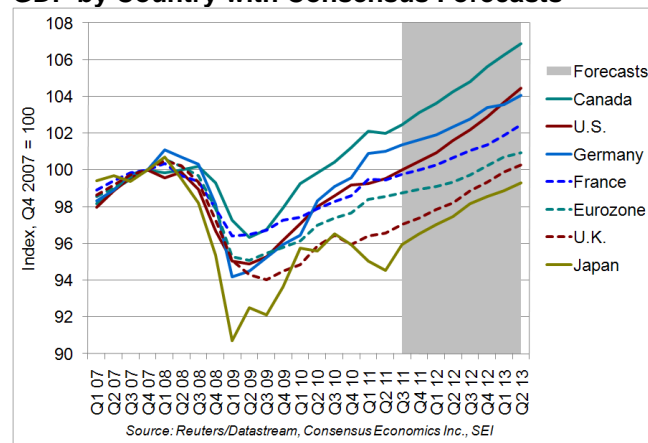
The third quarter of 2011 was one most investors will want to forget. Equity markets around the world tumbled sharply, while already-low Treasury yields in the benchmark 10-year bond broke decisively through 2% for the first time since 1950. Daily market volatility jumped toward levels last seen during the worst days of the financial crisis in the autumn of 2008. Economic news went from bad to worse—double-dip recession fears deepened throughout advanced economies; the European periphery debt crisis entered an even scarier phase as contagion struck Italy and Spain; and the U.S. government suffered the ignominious downgrade of its debt rating following a partisan battle over its credit limit. There is no arguing that the past few months have been simply awful—so awful, in fact, that we think the stage has been set for an improvement in equities and other risk-oriented investments over the next 12 months, most likely starting before year-end.

At first blush, such a bold pronouncement sounds outlandish and out of touch with the reality of the situation. The headlines on a daily basis provide a steady supply of negative news. Economic growth seems to have melted away. Economists cut their 2011 gross domestic product (GDP) growth estimates by one percentage point or more, depending on the country (although key developed economies are still forecast to grow slowly through mid-2013, as seen in Exhibit 1). Surveys of purchasing managers and consumers point to a veritable collapse in confidence. While we readily concede that these surveys of sentiment and expectations can serve as a useful warning system of impending cyclical change, it is important to consider that the results often overstate the actual strength or weakness of the economy.

Take, for example, the Philadelphia (Philly) Fed survey. This is a monthly survey of manufacturers in the Third Federal Reserve District, encompassing the states of Pennsylvania, New Jersey and Delaware. Participants indicate whether overall business activity at their companies has improved or deteriorated. They simply report how conditions in various areas—such as employment, working hours, shipments and new and unfilled orders, among others—compare to the previous month, and how they expect their businesses to fare over the next six months. The beauty of this type of survey is its simplicity. Plant managers can

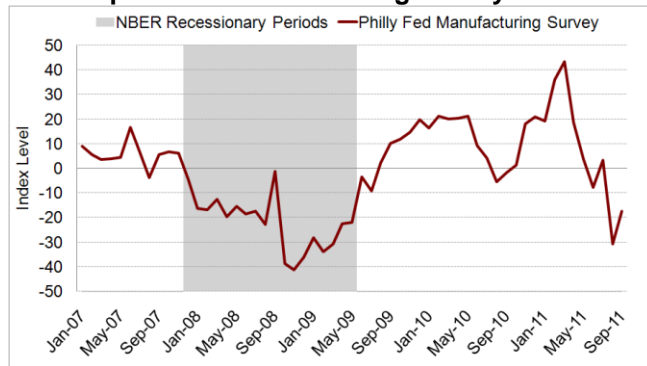
quickly answer the questions—it is easier to answer whether a business is improving or getting worse than it is to say by how much. The survey is therefore a valuable measure of the pervasiveness of a change within the business environment; if many manufacturers report a decline in activity—even a small decline—it will lead to a significant drop in the overall monthly figure.

**Exhibit 1
GDP by Country with Consensus Forecasts**



When the disappointing Philly Fed survey results were released on August 18, the impact was electric. Economists expected a small positive number for the month, but instead got a big negative number. The Philly Fed Index fell to its lowest level since February 2009, when the economy was still officially in recession (Exhibit 2). The S&P 500 slid 4.5% on the day of the report. So the critical question became: Is the U.S. in, or on the verge of, a recession? We think entering a recession is unlikely, as the main drivers of economic downturns—housing, business investment and durables consumption—are still at very depressed levels and it is hard to go lower when you are starting from the basement. But, for the sake of argument, if a *bona fide* recession were to become a reality, profits could fall at least 20% to 30% and equity prices would suffer nearly a 40% peak-to-trough decline.

**Exhibit 2
Philadelphia Fed Manufacturing Survey**



Source: Federal Reserve Bank of Philadelphia

So far, the S&P 500 has fallen less than 20% from its peak in April (although this benchmark exceeded 20% intraday on October 4). Evidently, U.S. investors have only partially priced-in a substantive cyclical decline. Of course, the equity market declines in other countries are more indicative of a full-blown recession. For instance, European markets on balance are down in price by some 25% year-to-date, versus 10% in the U.S. Meanwhile, Australia and several major emerging markets—including Korea, Hong Kong, India, Brazil, Chile and Mexico—are down nearly as much as Europe.

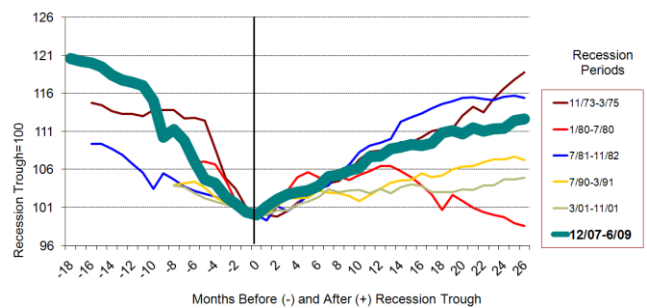
What's an Economist to Do?

According to the National Bureau of Economic Research (NBER), the official arbiter of when a U.S. recession begins and ends, a recession is defined as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale-retail sales.” Exhibits 3, 4, 5 and 6 highlight the major monthly economic series that weigh heavily on the NBER’s

recession-dating methodology. These charts illustrate the last six economic cycles, starting with the peak reading of each cycle, and index the bottom of each recessionary episode in economic activity at 100 for easy comparison purposes. The chart is then extended more than two years beyond the end of each respective downturn to compare the current expansion versus the previous five.

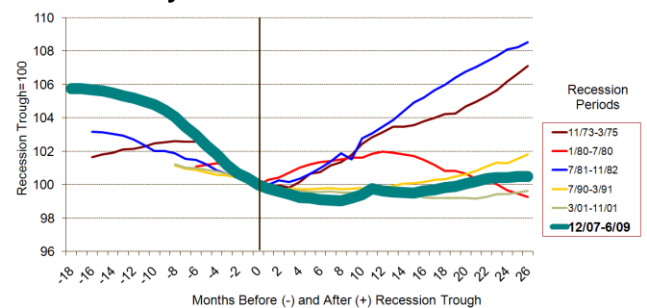
None of the four indicators are flashing a recessionary warning at this time. Industrial Production (Exhibit 3) has enjoyed a typical recovery over the past two-plus years. At the weaker end of the spectrum, non-farm payrolls (Exhibit 4) have been sluggish, culminating in a flat reading for the month of August in total non-farm payrolls (and only a minor gain in private-sector jobs). Only two episodes in documented history have weighed negatively on the jobs environment: the truncated recovery following the recession that ended in July 1980 and the “jobless recovery” coming out of the March 2001 to November 2001 downturn. An objective economic prediction suggests that the U.S. economy is still on the same slow-growing path that it has been on over the past two years. While there are some indications of a more pervasive weakness developing, this weakness is not yet pronounced or persistent enough to qualify as a recession.

**Exhibit 3
Industrial Production**



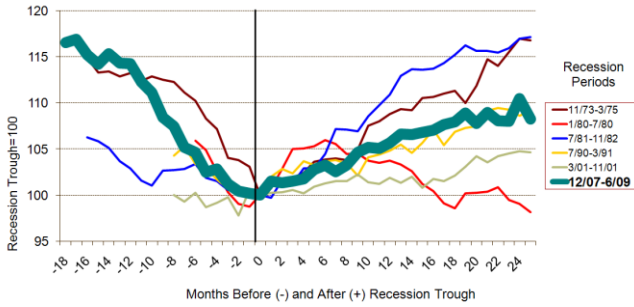
Source: United States Federal Reserve

**Exhibit 4
Non-Farm Payrolls**



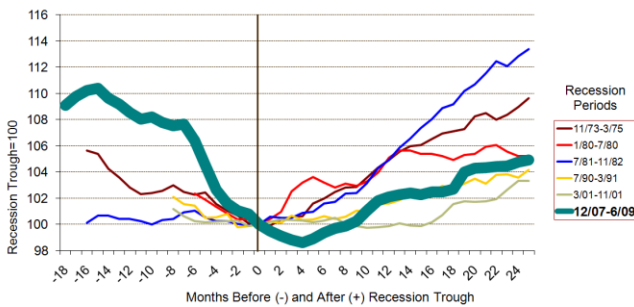
Source: Bureau of Labor Statistics, U.S. Department of Labor

**Exhibit 5
Real Business Sales**



Source: The Conference Board, Inc.

**Exhibit 6
Real Personal Income Less Transfer Payments**



Source: The Conference Board, Inc.

What’s a Policymaker to Do?

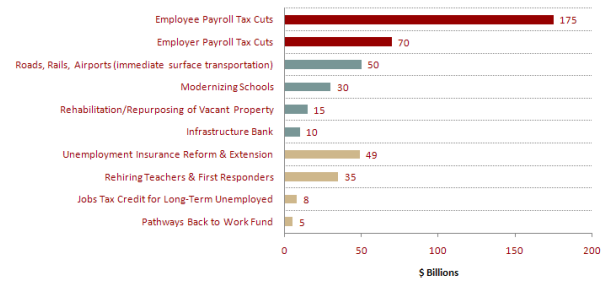
The widespread angst over the economy is understandable. In the entire post-World War II period, the U.S. has never experienced such a slow and tepid improvement in labor-market conditions following a deep recession. What is even more disconcerting is the seeming inability of the government to establish a monetary or fiscal policy to place the economy on a faster path. At best, one can argue that extraordinary measures taken by policymakers—such as the \$825 billion stimulus enacted in 2009, the Troubled Asset Relief Program, the bailouts of the automakers and the government-sponsored mortgage lenders, the Federal Reserve’s (Fed) quantitative easing programs and zero-interest rates, to name only a few—prevented a more drastic meltdown.

Despite these accomplishments, the fiercely partisan battle over the U.S. debt ceiling and subsequent rating downgrade reinforced the general impression that Washington lacks the political will to deal forcefully with the country’s economic problems. We hoped that the August recess and feedback from irritated constituents would encourage an increase in bipartisanship. Our hopes are starting to seem less realistic, however, in the buildup to next year’s elections and the lack of common ground that exists between the two parties. Partisan fighting over

relatively minor matters, such as how to fund the Federal Emergency Management Agency (although a compromise was eventually reached), points to a continuation of the gridlock that could stymie a quick and forceful response to an economic emergency—whether home-grown or blown toward America from across the Atlantic.

All is not lost, however. For example, we expect President Barack Obama’s recently unveiled \$447 billion American Jobs Act to be passed in some form (the means to pay for the measure will be a much harder negotiation). Maintaining the payroll tax cut for employees, extending payroll relief to employers and renewing extended unemployment insurance benefits are measures that appear appropriate given the sluggish jobs market and the large number of long-term unemployed—more than 75% of the cost of the Jobs Act is in the form of such tax-related and unemployment compensation relief (Exhibit 7). The “infrastructure” proposals—modernizing schools, roads and airports and creating an “infrastructure bank”—appear a little more questionable since they harken back to previous “shovel-ready” stimulus packages. To put a kinder spin on these measures, it will help mitigate the spending cutbacks and revenue increases that are certain to continue next year at the state and local levels of government.

**Exhibit 7
President Obama’s \$447 Billion American Jobs Act**



Source: www.whitehouse.gov

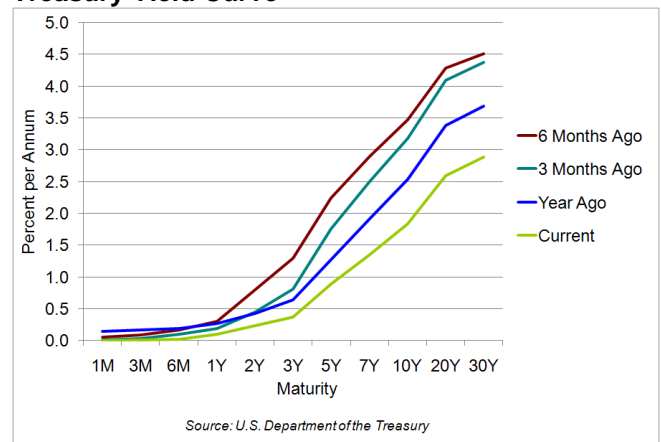
In our view, the prosperity of the nation will depend on the private sector and on the growth in business profits and revenues. The private sector creates wealth, while the public sector redistributes it. Both are vital functions in a well-ordered society. The first step is the creation of wealth. Reducing regulatory uncertainty should, in our opinion, move higher up on the agenda. President Obama took a big step in that direction in early September by halting the implementation of new Environmental Protection Agency ozone regulations. Various estimates had placed the cost of the regulations between \$20 billion and \$90 billion per year (depending on the whether the think-tank doing the calculation leans Democratic or Republican).

Republican legislators will be pressing the President to eliminate, delay or modify a raft of other big-ticket initiatives, including those embedded in the financial and health-care reform legislation.

In the latter half of November, the so-called Super Committee, tasked with finding longer-term spending cuts and revenue increases (as well as additional savings to offset the costs of the American Jobs Act proposals), will present its suggestions. This is another opportunity to dust off many of the deficit-reduction measures that were proposed last December by the National Commission on Fiscal Policy and Reform. At that time, more than \$4 trillion of spending cuts and revenue increases over a 10-year span were identified. Entitlement reform, the broadening of the tax base and across-the-board spending restraint will need to be part of any comprehensive package to bring fiscal policy onto a more sustainable track. Compromises will be inevitable—the big questions are how many compromises will be made now and how many will be delayed until after the 2012 elections. Reforms in the here and now may be incomplete and wholly unsatisfying to partisans on either side. We suspect even an imperfect agreement will be greeted with relief by the markets. Unlike the fiscal situation in much of Europe, the problems facing America are still perceived as solvable—given the political will.

On the monetary policy side, investors are waiting to see what kind of rabbit Fed Chairman Ben Bernanke can pull out of his hat now that Operation Twist has been unveiled amid a fair degree of skepticism from economists and investors. In his Jackson Hole speech in late August, the Chairman committed the Fed to keeping the funds rate near zero at least through the middle of 2013. This pledge helped pull rates down along the maturity spectrum (Exhibit 8)—a very nice trick, involving no bond purchases of any kind. Yields at the long-end of the yield curve have fallen significantly further in recent weeks, although that flattening, in our opinion, reflects investor fear as much as Fed intervention.

Exhibit 8
Treasury Yield Curve



Since another round of quantitative easing that would balloon the Fed's balance sheet was judged to be a non-starter, the Fed has opted instead for targeted purchases of intermediate- and longer-term bonds that would be paid for by the sale of shorter-maturity holdings. That gambit is unlikely to do much for economic growth. Chairman Bernanke himself correctly noted the primacy of fiscal policy in the government's tool-kit in his Jackson Hole speech.

In SEI's view, the Fed already has done its job by successfully preventing a slide into Japanese-like deflation and taking the steps needed to prevent a collapse of the banking system. Core inflation, for example, has been rising of late, running at close to a 2% annual rate. The money supply (as measured by M2¹) has skyrocketed at an annual pace in excess of 25% in recent months (reflecting money flows repatriated by banks and money market funds from abroad). Lending standards in the U.S. continue to ease, loan delinquency rates are falling, consumer credit is accelerating and business lending has perked up. Even the value of the dollar has turned upward, not just against the euro but also versus a broad selection of advanced- and emerging-country currencies. The U.S. financial system may not be the picture of health, but the trends have been going in the right direction. The markets nevertheless remain in turmoil because no one knows if the U.S. is sufficiently ring-fenced against a European disaster.

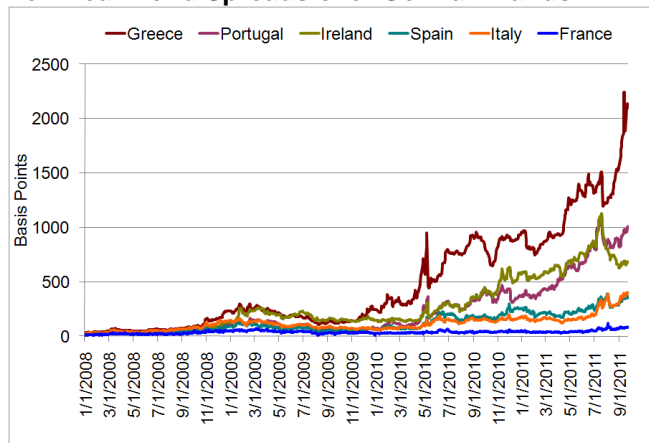
¹ The M2 measure of the money supply includes cash in circulation, travelers' checks of non-bank issuers, checking accounts, savings accounts, smaller CDs, non-institutional money market accounts and overnight repos at commercial banks.

What's a European to Do?

The sovereign debt crisis in Europe deepened dramatically during the third quarter. Investors priced in the growing odds of a Greek default, the extension of contagion risks beyond the smaller issuers of the periphery to Spain and Italy and the possibility of a full-blown banking crisis in France as a result of French financial institutions' heavy exposure to the troubled debtor nations. Efforts to stanch the crisis have yet to bear fruit; indeed, those very efforts seem to produce only more drama and discord. Purchases by the European Central Bank (ECB) of Italian and Spanish paper, for example, sparked the recent resignation in protest of the German representative from the Bank's executive committee.

The crisis continues to metastasize. Greece will likely default by early November, unless the next tranche of bailout money is released by the so-called "Troika"—the European Commission, the ECB and the International Monetary Fund (IMF). As we have pointed out in other reports, the situation in Greece is turning desperate. The contraction in real GDP has accelerated in recent quarters, blowing a hole in the government's fiscal projections. However, creditors continue to push for higher taxes, wide-ranging market economic reforms and asset sales. As can be seen in Exhibit 9, which tracks various countries' benchmark-bond spreads against German bunds, Greek debt is priced for default. The only questions include: When will default occur and will it be an orderly or a disorderly affair? It seems investors are betting that default will come sooner rather than later and that it could be messy.

Exhibit 9
Ten-Year Bond Spreads over German Bunds



Source: Thomson Reuters Datastream

When one comes down to it, though, Greece is the sideshow because of its small size and the fact that a large portion of the country's debt is now backstopped by governments and official institutions. The bigger problem is contagion extending to Italy and Spain. Bonds in both countries have seen spreads widen to new crisis highs versus bunds—to levels roughly similar to where Irish and Portuguese bonds were trading only one year ago, and where even Greek bonds were trading about 18 months ago. Unfortunately, the political will to deal decisively with the issue still appears to be lacking, and the financial system's ability to absorb the losses that may ultimately result continues to be questioned by investors.

Similar to the uncertainties that accompanied the subprime crisis in 2008 or the Japanese real estate bust of the 1990s, the size and scope of the European sovereign debt problem remain in dispute. Christine Lagarde, the new head of the IMF, has urged a recapitalization of European banks, while bankers and politicians continue to argue that the crisis is essentially one of liquidity, not solvency. In our view, the European debt crisis will continue to roil markets until the tools are in place to handle the systemic risk arising from a material deterioration in Italian and/or Spanish bond prices. These tools could include a further beefing up of the European Financial Stability Facility (and its permanent successor, the European Stability Mechanism), a more realistic valuation of sovereign debt on banks' balance sheets, extensive capital-raising by financial institutions, a closer fiscal union that permits the issuance of euro-area bonds and a more explicit guarantee that the ECB is prepared to act as bond buyer of last resort. It also would recognize the insolvency of Greece and take steps to write off those bad debts, perhaps in conjunction with the departure of Greece from the euro currency framework. Each one of these "solutions" carries risks, and each one faces intense opposition. A reasonable person may doubt whether they will be implemented in a decisive and timely manner. The endgame still lies ahead and it is as unclear as ever.

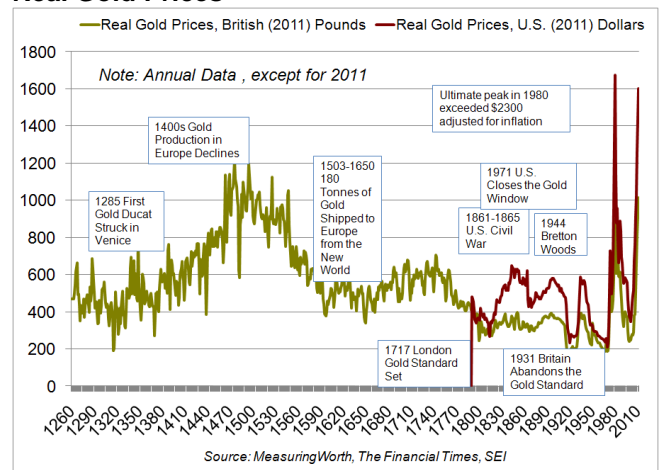
The ongoing debt crisis, signs of flagging economic growth in Germany and a more dovish-sounding ECB combined to push the foreign exchange value of the euro below \$1.40 for the first time in about six months. We think the tendency is for the euro to weaken further, although both the magnitude and the timing of any decline are hard to judge. It is clear, though, that some props that have supported the currency have weakened. First, the ECB has reversed its interest-rate policy in light of these events. Whereas the expectation had been for policy rates to move higher

over time, the odds now favor an easing of monetary policy as the debt crisis and slowing economic growth raise recession concerns. In addition, economists continue to see the bulk of the eurozone as an excruciatingly slow grower versus emerging markets and North America. Although we are not concerned that Germany's economy will suddenly run out of steam, a distinct loss of momentum appears to be in the cards. Finally, and most importantly, the debt crisis itself will continue to exert a strong influence on the euro's movements, both up and down—but mostly down.

Unfortunately, when it comes to fiat currencies, the number of safe havens has been reduced by one. The Swiss franc plunged in early September, following the Swiss National Bank's announcement that it would set a minimum floor at which the franc would trade to the euro. In early August, the Swiss National Bank adopted a zero-interest-rate policy and a quantitative easing program, although neither of them produced the desired result. Investors are thus facing an ugly contest in which countries are purposely trying to debase their currencies in an effort to improve their international competitiveness against each other. It is little wonder that gold prices have climbed sharply this year (although volatility has increased too).

Exhibit 10 takes a trip some 750 years back in time. It charts the price of gold, adjusted for the cost of living, about as far as one can go in the historical record. 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 price of gold in real terms is relatively high at present. At about \$1,600 per ounce, today's gold price is almost even with the annual average recorded in 1980 (although the peak in prices that year hit an astounding \$2,300 in today's money). The current price of gold is now well above those of much of the inflationary 1970s or periods of great economic and societal stress, such as the Civil War, the Great Depression and the two World Wars. Reviewing gold in sterling terms, the real price of gold is around the historical peak during the 1400s—a time of chronic gold shortages. It was the high price of gold at that time that contributed to the ocean-faring adventures of Christopher Columbus and others.

Exhibit 10 Real Gold Prices



Gold is not an asset that fits easily into our allocation models. This is partly owing to the fact that the yellow metal has little in the way of intrinsic value. It pays no dividend. It provides no cash flow or earnings. 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 a positive real return over time until relatively recently, while exposing investors to extreme draw-downs.

Yet, we understand the rationale behind the surge in price. Zero-interest-rate policies from America to Switzerland have greatly reduced the carrying cost of holding bullion. In addition, distrust of government fiscal, monetary and currency management is extremely high. For many, the word “fiat,” as in fiat currency, is one of those four-letter words that should not be said in polite company. The search for a hedge against the potentially inflationary actions of governments has driven many investors (including central banks) to the metal. This demand is only enhanced by the strong growth in emerging economies and the increasing affluence of their populations.

We will not hazard a guess as to where the ultimate peak gold price will be or when it will occur. However, the accelerated rate of appreciation and the rising volatility is itself a warning sign that a stiff correction could occur soon. In view of the fact that the gold price has tumbled some 13% since early September, the correction may already have started.

Emerging Economies: In Search of a Soft Landing

The extremely sluggish economic conditions in the U.S., Europe and Japan have provided a sharp contrast to the mostly buoyant growth registered by developing economies over the past two years. As the economic and financial woes of the advanced world accumulate, however, policymakers in Asia and Latin America appear to be reconsidering their priorities and courses of action.

Brazil, for example, cut its policy interest rate recently to 12% from 12.5%, despite an uptick in Consumer Price Index inflation to a year-over-year gain of 7.2%. Inflation-adjusted interest rates, however, remain exceptionally high compared to the other so-called “BRIC” countries (Brazil, Russia, India and China) that have real rates close to zero or even less. A stubbornly strong currency has caused industrial production to flatten over the past year. With growth prospects ebbing in developed countries, there is concern that trade pressures will intensify. We would not be surprised to see more interest-rate reductions in the months ahead.

China also seems to be moving away from the progressive monetary tightening that has been taking place to combat rising inflation, despite an inflation rate that remains above 6%. Although growth in GDP, industrial production and retail sales is still expanding at a very strong pace, money supply growth has eased considerably. Analysts appear sanguine that China will achieve a soft landing, with GDP growth in the year ahead easing toward an 8% rate versus the near-double-digit rate of the past few years. This remains to be seen. In previous reports, we made mention of the possible misallocation of resources that could result from the credit boom in that country. The sharp pullback in Chinese equities—the MSCI China Index is down almost one-third in the year to date versus 28% for the MSCI Emerging Markets Index and about 15% for the MSCI World Index—suggests that investors are no longer impressed by growth alone.

Our favorable fundamental view on emerging-market economies has not changed, however. Growth prospects remain far superior to those in developed economies. Growth should remain in excess of 4.5% in terms of real GDP, with even faster growth in many emerging Asian countries. Accumulation of foreign reserves should continue to help buoy currencies (although, as we mentioned earlier, the dollar has climbed sharply against a variety of emerging-economy currencies in recent months). We find it

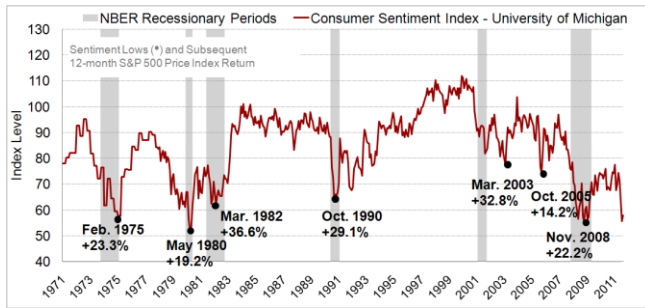
meaningful that, in the last three months, rating agencies have upgraded the sovereign debt of 17 emerging-market countries, while downgrading only three—with two of the three downgrades merely reflecting changes in methodology, not fundamentals *per se*.

What's an Investor to Do?

The extreme volatility in global financial markets, widespread fears of a double-dip recession in the U.S. and Europe and the angst surrounding the European debt crisis have turned investors outright bearish about the future. We have witnessed strong outflows from stocks and the riskier fixed-income classes into the safe havens of Treasury bonds, German bunds and money market funds.

We believe this herd instinct to run for the hills will prove to be a mistake. Although the near term is admittedly fraught with uncertainty, we find ourselves becoming more optimistic about the longer-term outlook for riskier assets. The very fact that sentiment is so sour is itself a strongly bullish signal. Exhibit 11 tracks the University of Michigan's Consumer Sentiment Index and hones in on the cyclical low points of the past forty years. The chart aligns those low points with the performance of the S&P 500 (price only) over the following 12 months. The results are extremely constant: When sentiment declined to the bearish levels seen in the data, the stock market consistently posted very strong gains over the subsequent 12 months. The increase in prices from the drop in sentiment has ranged from a low of 14% (October 2005 to October 2006) to a gain of over 36% (March 1982 to March 1983). Although the majority of the lows in consumer sentiment occurred in the midst of recessions, there have been occasions when sentiment hit cyclical lows (2003 and 2005) without the economy entering a slump. We are obviously assuming that current sentiment is near a cyclical trough, and are comfortable in making that assumption. Sentiment is nearly as low as it was in February 1975 and May 1980—times that were quite challenging, with high unemployment *and* double-digit inflation and interest rates.

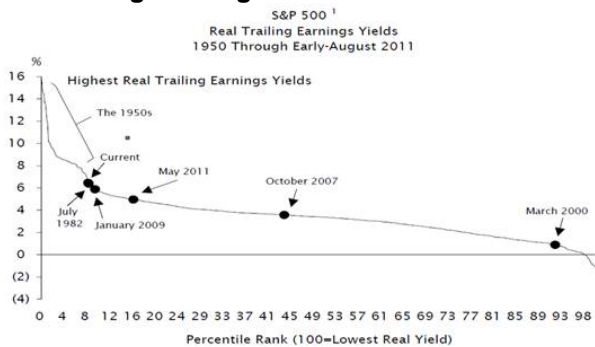
**Exhibit 11
Consumer Sentiment Index**



Source: University of Michigan

There is little question that a lot of bad news is priced into equities. Exhibit 12 examines the inflation-adjusted earnings yields (i.e., the inverse of the price/earnings ratio) since 1950, sorting the earnings yield from highest (most attractive) to lowest (least attractive). On a four-quarter trailing basis, the real earnings yield is currently well within the top decile of returns, in the same neighborhoods of those recorded near the end of the 2007 to 2009 bear market and at the end of the 1966 to 1982 secular bear. Only the 1950s sported earnings yields that were consistently higher. More bearish investors who think a recession is upon us would argue that earnings yields will fall as profits decline. This is true—but even if one assumes a 30% decline in S&P profits over the next year from the second quarter’s current run rate of \$100 per share, the real earnings yield would be near 4.5%, still near the top quartile ranking.

**Exhibit 12
Real Training Earnings Yields**



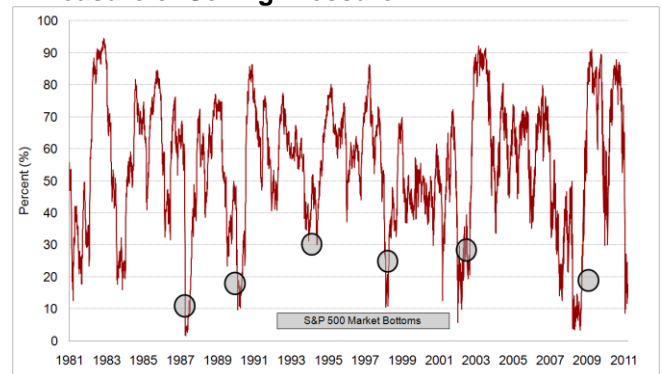
Source: Robert Shiller, Standard & Poor’s, Corporate Reports, Empirical Research Partners Analysis.
¹ Capitalization-weighted data. Trailing earnings yields less the core CPI. Prior to 1958 the overall CPI is used.

We realize that valuation metrics, such as earnings yields and price-to-book ratios, are not terribly useful as timing tools. Cheap assets can get cheaper and expensive assets can get richer. John Maynard Keynes was speaking from personal experience when he wrote that “markets can remain irrational longer than you can stay solvent.” However, it is not completely clear that markets are irrational at this

point. Yes, risky assets have been declining because the news has been terrible. Uncertainty has engendered selling and the search for safe havens. All we are saying is that prices have fallen to the point where a fair amount of bad news has already been priced in. To see prices fall lower, the bad news will need to get much worse. Baron Nathan Mayer Rothschild (1777-1836), one of the founders of the legendary Rothschild family banking dynasty, supposedly said, “Buy when there is blood in the streets, even if it is your own.” These words resonate strongly in our own time.

The performance of the U.S. equity market in recent weeks has been consistent with the sort of repair process that often signals a market bottom. Prices are volatile, but contained in a range bounded (at least in terms of the S&P 500) by the panic low of 1,100 established in early August and the 1,250 level that had represented the low end of the previous trading range. Exhibit 13 highlights the intensity of the decline over the past two months. The percentage of stocks trading above their 52-week average tumbled to a mere 7% by August 8. This is a level consistent with other important market bottoms. With prices and sentiment stretched to the downside, we believe the odds favor an eventual push to higher levels as the year comes to a close.

**Exhibit 13
A Measure of Selling Pressure**



Source: Ned Davis Research, Inc.

All we need is a positive catalyst. Unfortunately, we do not know what that catalyst will be. Perhaps it will be a re-acceleration in business activity out of the soft patch of recent months. Or maybe markets will respond to the continuation of relatively robust corporate earnings results. The catalyst could even be something counterintuitive, such as Greece finally opting out of the euro, provoking the cathartic crisis and capitulative decline that ultimately leads to a durable solution to the periphery debt problem. Keep in mind that the secular bull market in equities started August 12, 1982, the same day as Mexico’s announcement that it

would no longer be able to service its debt. There were many years left to run on the Latin American debt crisis back then, but that did not stop equities from starting their historic 18-year bull market.

We thus continue to recommend a moderate tilt toward equity and credit, despite the uncertainty and the pain sustained. This tilt is expressed in our active asset allocation accounts accordingly:

1. We favor stocks over bonds. Although the economic outlook has been downgraded by economists, the data still support a positive view of overall business activity in the U.S., the European core economies and developing markets. Equities are expected to benefit from continued earnings growth and exceptionally low valuations.
2. We favor U.S. large-cap equity over European and Japanese stocks. The U.S. enjoys stronger structural growth, better demographics and the privilege of having the world's reserve currency. Although U.S. equities posted very strong relative performance in the year to date and are priced more expensively than European and Japanese equities, we think this relative strength can continue, especially for unhedged, dollar-based investors. Until the endgame for the periphery debt crisis comes into clearer view, the U.S. will likely benefit as a safe haven.
3. We favor high-yield bonds over Treasuries and investment-grade debt. High-yield bonds appear priced for a recession that we do not think will materialize. They now sport a yield of eight percentage points over 10-year Treasury bonds, and are priced for an implied default rate of about 8% versus an actual default rate of 2%. The heavy re-financing of debt over the past two years has pushed the "maturity wall" several years into the future, providing companies additional financial flexibility.
4. We remain neutral to emerging-market debt and equity. Although emerging-market debt offers a substantial yield premium to U.S. investment-grade bonds and safe-haven sovereign debt, it is a long-duration asset and would be negatively affected by an increase in bond yields. With regard to emerging-market equity, economic growth prospects remain an important positive factor, but we believe that valuations relative to developed markets are somewhat expensive.

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