

Themes for 2011: Cautiously Optimistic

By: SEI Fixed Income Portfolio Management

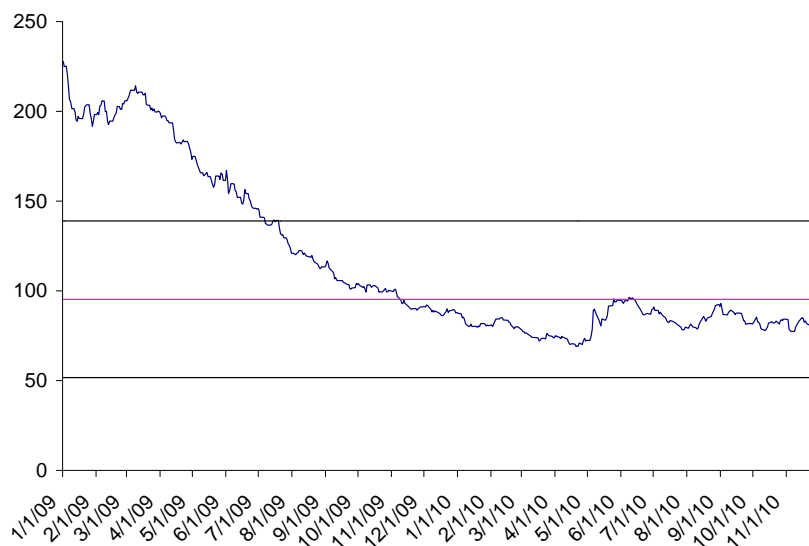
SEI Fixed Income Portfolio Management manages fixed-income strategies for SEI's Managed Account Program (MAP).

2010: The Year in Review

Excitement was prevalent on a global scale in 2010:

- In the United States, additional quantitative easing by the Federal Reserve (Fed) and further labor market disappointments were in the limelight.
- Across the pond, sovereign debt crises, banking fears and austerity measures created headwinds and plagued the European markets.
- Our Sentiment Index, shown in Exhibit 1, continued to show overall signs of improvement over the course of the year, even as the markets and the economy continued to be heavily tested.
- The Federal Reserve remained accommodative (too accommodative by some views).
- We carried one of the more dovish views on when Fed tightening would begin, and even then we weren't dovish enough. The second round of quantitative easing (QE2) was not expected at the beginning of the year, and its implementation will push rate hikes even further into the future.
- There was hope of a stronger recovery within the labor market even before QE2.
- Post-QE2, the labor picture remains weak, inflation remains low and the Fed remains accommodative in an effort to revive consumption and help bolster the economy.

Exhibit 1: SEI Sentiment Index



2011: The Year Ahead

We believe the following themes will be at the forefront in 2011:

- Shareholder-friendly actions by corporations
- A slow march higher for the London Inter-Bank Offered Rate (LIBOR)
- A higher saving rate among households, which could become deflationary
- Treasury yields trending higher
- Continued sovereign debt and banking woes in Europe
- Funding concerns for U.S. states and municipalities

Shareholder-Friendly Activity

Over the past 12 months, we have seen many corporations improve their balance sheets by retiring outstanding debt through callbacks and other means, while also taking advantage of the low interest rates resulting from the Fed's accommodative actions by issuing new debt. Increases in merger and acquisition (M&A) activity, share buybacks and dividend increases have been made possible by healthier corporate balance sheets. The fact that companies are cash-rich, and equities as a whole remain fundamentally cheap, should start to create some concerns for bondholders. Exhibit 2 highlights well-known companies that have large cash balances. All but Microsoft have significantly higher cash balances than they did coming out of the recession of 2001¹. When companies hold large amounts of cash on their balance sheets, bondholders feel more secure that repayment of a loan is likely. However, if companies start to use this money for M&A or to increase dividends to shareholders, creditors (bondholders) cannot look the other way.

Exhibit 2: Corporate Cash Balances

Company	Total Cash, \$ Billions		
	6/10/2010	12/1/2001	Change
Cisco	39.8	7.5	32.3
Oracle	23.6	4.9	18.6
Amgen	14.5	2.6	11.8
J&J	18.9	7.9	10.9
Pfizer	19.2	8.6	10.6
GE	12.8	2.2	10.5
Dell	12.4	3.9	8.5
Coca-Cola Co.	10.1	1.9	8.2
Wal-Mart	10.1	2.1	8.0
HP	14.7	7.1	7.5
Intel	18.3	11.5	6.7
Merck & Co.	9.9	3.2	6.6
Boeing	8.6	2.3	6.3
IBM	12.2	5.9	6.2
Exxon	13.2	7.2	6.0
Chevron	9.4	3.7	5.6
Ford	21.8	18.7	3.1
Microsoft	36.7	38.2	(1.4)
TOTAL	345.9	140.3	205.5

Source: Moody's, SEI

¹ Recession dates defined by NBER: March 2001 – November 2001, December 2007 - June 2009

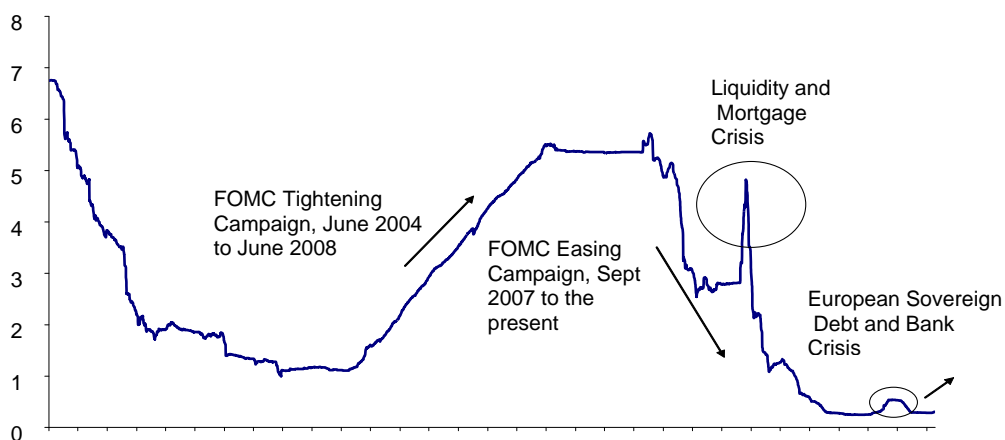
Bondholders' concerns could be overdone, however, as corporations in general have strong free cash flows, and any negative implications for creditors are very company-specific. Like the equity markets, fundamentals within the credit markets remain healthy. Corporate leverage continues to decline while companies are flush with cash, and demand from foreign investors is likely to remain high. Combined with our view that Treasury rates will move higher in 2011, this creates an environment that should be conducive to further spread tightening. A key difference from 2010 will likely be the returns generated in the credit sector. Depending on the maturities and sectors, many fixed-income investors realized close to double-digit returns in 2010. In 2011, credit market returns are likely to seem paltry in comparison. We expect the sector to provide primarily coupon returns with only small capital gains or losses.

LIBOR: A Slow March Higher

The three-month LIBOR rate is one of the best ways to measure risk and uncertainty within the banking system. There are 16 member-panel banks that contribute to setting the rate for inter-bank loans. When stress and strains are absent from the system, LIBOR volatility tends to be minimal. However, this is not always the case. There has been significant LIBOR volatility over the past few years as U.S. and European banks dealt with solvency and liquidity issues.

As shown in Exhibit 3, LIBOR has a tendency to track activity of the Federal Reserve Open Market Committee (FOMC), which sets the target for overnight interbank lending rates (the Fed Funds rate) in the United States. Driven by investor expectations, the three-month LIBOR rate may have a tendency to lead FOMC activity. For example, as the FOMC marched rates higher from 2004-2006, the spread between three-month LIBOR and Fed Funds at times exceeded its historical average. In a static interest-rate environment (which of course is not always the case), three-month LIBOR trades 12-15 basis points above the FOMC's Federal Funds target rate on average. We believe that LIBOR has bottomed out, or at the very least has little room to move lower. Three-month LIBOR bottomed out approximately 18-20 months after the prior two recessions were declared over. The most recent recession started in December 2007 and ended in June 2009. December 2010 marks 18 months since the end of the recession, the beginning of the point at which LIBOR has tended to bottom.

Exhibit 3: Three-Month LIBOR



Source: Bloomberg, SEI

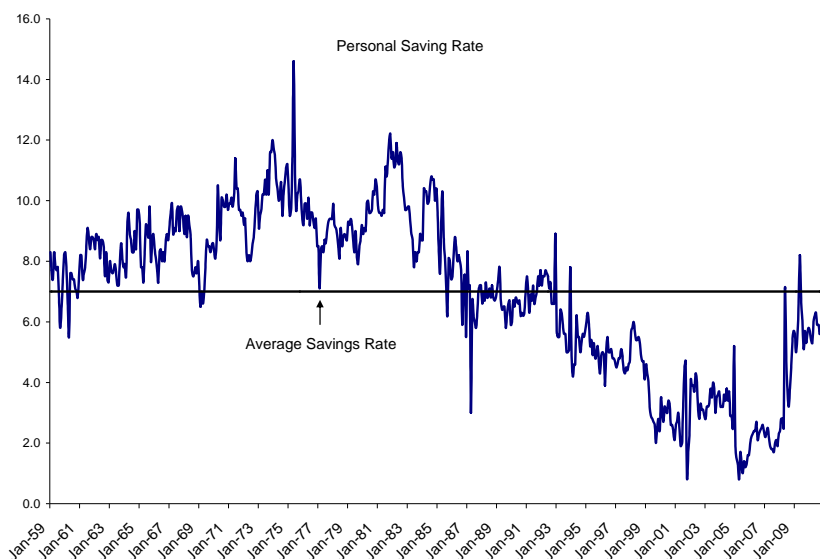
In addition to this historical perspective, there are forces at work that could push LIBOR higher in one of two ways. The “glass half empty” view is that banks and governments in Europe are still facing liquidity and solvency issues. If these ongoing stresses continue to build, bank funding and government financing will become more difficult to attain, and LIBOR should move higher as lenders seek compensation for rising systemic risk. The “glass half full” view is that fiscal and monetary stimulus measures will eventually produce positive results as they work through the economy and markets. In that case, improved prospects for economic growth could also push overnight lending rates higher, including LIBOR. This scenario may take a few quarters to play out, but the groundwork is set.

Households: Too Much Saving Could Prove Deflationary

Households have taken the past two years to rebuild their balance sheets by increasing savings and paying down debt, a process that has probably not yet run its course. A rise in personal savings was needed to facilitate this process, as the average savings rate from 2005-2007 was a mere 1.9%, while the historic average since 1959 is right around 7%. (Exhibit 4 below provides an overview of historical savings patterns.) The Employee Benefit Research Institute reports that 47% of early Baby Boomers and 44.5% of Generation X are likely to fall short of the money required to pay for basic living expenses like food and electricity in retirement. From that point of view, a higher savings rate is a good thing.

However, increased savings is not helpful to an economy exiting a recession. While household balance sheets need to be repaired, consumer spending (ideally with cash and not on credit) is necessary in order to see a self-sustaining recovery.

Exhibit 4: Personal Savings Rate



Source: U.S. Department of Commerce: Bureau of Economic Analysis

Too much saving could unleash deflationary pressures. Baby Boomers who continue to work (by choice or not), change jobs, or retire will likely change their spending habits and patterns. Any decrease in income will decrease spending and therefore create less demand for goods.

The relationship between the savings rate and consumption is something that we will be watching closely. If the savings rate continues to climb without consumption picking up, the increasing number of households that delay purchases in hopes of seeing lower prices is likely to push prices lower in a pattern similar to what we have seen in the housing market. The difference is that deflationary

pressures would impact more than just one sector this time around. If deflationary expectations become entrenched among households, consumption patterns could be impacted significantly. While we do not have a specific savings rate that we view as ideal, we do believe that the 5.7% average seen over the past 2 years is an improvement over the low rate that preceded it. However, if this number approaches the historical average, we will be watching consumption levels closely to see if they start to falter.

Europe’s Woes: Bank Solvency and Government Finances

The threat of sovereign defaults in Europe remains prevalent. Chapter One of the current episode involved Dubai World’s debt in 2009-2010. Chapter Two involved Greece and more recently Ireland. The coming year is likely to bring additional chapters, featuring Spain and Portugal.

Ireland’s decision to accept European Union (EU) and International Monetary Fund (IMF) aid will place added pressure on Portugal and some other countries to do the same. Portugal’s situation is slightly different than Ireland’s, however. Unlike Ireland’s banking problems and government debt worries, Portugal is facing low growth and high public-sector deficits, which are causing liquidity issues. Portugal has a goal of reducing its budget deficit as a percent of GDP from 7.3% to 4.6% by the end of 2011 through civil-servant wage cuts, freezing retirement pensions and increasing the value-added tax by 2%. While these austerity measures may help reduce budget deficits, they won’t spur the much-needed growth.

Exhibit 5 shows the strain on the finances of some European governments. The chart highlights outstanding debt and deficit levels as a percentage of Gross Domestic Product (GDP). While these measures vary quite a bit, elevated levels of debt or deficits in any one country create increased funding costs and the threat of financial contagion for all European Union governments and European banks.

Exhibit 5: European Debt Levels (as of 12/31/09)

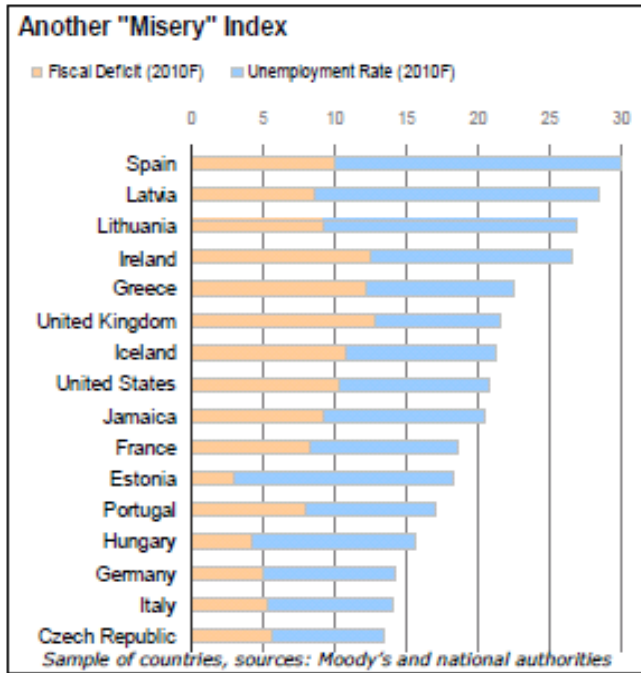
	Debt as % of GDP	Deficit as % of GDP
Italy	116.0%	5.3%
France	78.1%	7.5%
Portugal	76.1%	9.3%
Germany	73.4%	3.0%
Spain	53.2%	11.1%

Source: Bloomberg, Eurostat

Due to contagion concerns, the Euro remains under pressure. Moody’s Misery index², shown in Exhibit 6, adds a country’s unemployment rate to its fiscal deficit as a percentage of GDP. It’s apparent from the chart that fiscal risks and strains persist among many European nations (a higher index reading presents greater cause for concern). The combination of large deficits and high unemployment alone is troublesome. Add concerns about banking system solvency to the mix and you have a recipe for trouble.

² Data shown is for countries’ fiscal year 2010.

Exhibit 6: Misery in Europe



Source: Moody's

The threat of contagion in 2011 will create a challenging environment for investors in these regions. The lingering question is whether there will be enough funding available to fix the problems. Also of concern is how much a significant backup in interest rates will affect bank balance sheets. And this problem doesn't just impact the European banking system. A sharp move higher in rates will also hurt U.S. bank profits. However, at this point in time, European banks are clearly in a more precarious position. We feel that all the actions taken to date are a temporary fix. These problems will need to be dealt with again in a couple years, which poses a challenge to those who invest directly in the sovereign debt of these ailing countries, as well as to investors with indirect exposure.

Treasuries: More (and Less) of the Same

We believe that the Treasury market in 2011 will carry many of the same themes from prior years. December 2010 has already set the stage for similarities to December 2009 Treasury price action. For example, we witnessed the 5-year Treasury yield rising by 68 basis points in December 2009, and December 2010 has shown similar activity. This similarity doesn't show the entire picture, though: if we look back to November 4, when the cycle's low yield of 1.03% was reached, the move is much larger than last year's correction. This should be expected as the economy and markets are on more solid footing at this time.

Despite the December 2010-December 2009 similarity, we're likely to see a different outcome within the Treasury sector in 2011. There were two wild cards for Treasuries at the start of last year. The first one was uncertainty around the Fed's actions in 2011, and the second was uncertainty around the effects of a massive new supply of Treasury debt. These uncertainties have largely been resolved. Today, quantitative easing is well under way with QE2. While Chairman Bernanke has left the door open to additional measures if needed, their likelihood is low given the massive political backlash from various foreign central banks and some U.S. politicians. It is likely that the Fed will remain in a prolonged holding pattern due to the high unemployment rate and the fact that inflation is expected to remain low.

The spread between two-year and ten-year Treasury yields is likely to steepen early in the year before flattening. Exhibit 7 shows that a sharp move has already occurred, led by the sell-off of the ten-year (known as a bear steepener, since the steepening results from lower prices for the ten-year). The anticipated move in early 2011 will be driving higher prices for two-year Treasuries (known as a bull steepener). As in prior years, the Treasury is likely to let its Supplementary Financing Program wind down as the national debt ceiling is approached, and this is likely to cause the yield on the two-year note and general collateral for repurchase agreements to fall as demand outweighs supply. Once corrected, the combination of new supply at the short end and monthly QE2 purchases by the Fed in the 10-year space is likely to create a curve-flattening bias.

Exhibit 7: Two-Year/Ten-Year Treasury Spread Levels



Overall, we expect Treasury prices to move lower, pushing yields higher in 2011 (although a large portion of that move has already occurred in December 2010). Improving expectations for the global economy will support an upward trend in yields, albeit in a choppy fashion. The European banking and debt dilemma and forecasts for a reduction in Treasury supply will help put a ceiling on rates and contribute to volatility. China and Japan remained the largest foreign holders of U.S. Treasuries as of September 2010, and although concerns remain from global investors around U.S. deficits and the U.S. dollar, we feel that the demand from foreign investors will remain strong in 2011. This demand, together with Fed purchases, should help absorb new net issuance in 2011.

Municipal Markets: The Pain Trade Continues

The pain trade is what investors in the municipal markets felt in 2010, and it is likely to continue through 2011. Participants have felt the pain from both a fundamental and a technical perspective. Similar to the taxable market, low yields have pushed investors out the yield curve and into longer maturities or down in credit quality at a time when many states remain challenged by budgetary woes. Investors also have to navigate through funding, fiscal and budgetary concerns.

The states and their local governments continue to deal with budget deficits arising from lower collections from all revenue sources including property, sales and income taxes. Property taxes, which usually make up the majority of revenues, are lower due to continued softness in the housing market. Sales tax revenue remains low due to a marked decrease in consumer spending. We have started to see a pickup in consumption from consumers, albeit at a slow and choppy pace, and this increase in consumption will take time to work through to state and local revenues. Credit pressures remain within the sector but are primarily affecting lower-quality names. This was evident as a large portion of the high-yield sector was downgraded in the fourth quarter of 2010, which created some forced selling among institutional investors.

In 2011, muni markets will be influenced by how the states handle decreasing revenues and increased funding needs. With the likely end to the Build America Bond Program, funding will remain challenging for many states. Given these conditions, the municipal market will remain a buyers' market. In particular, the long end of the curve will be tested, which should provide opportunities to patient investors. The lack of Build America Bond supply will be replaced with traditional tax-exempt supply, which should add upward pressure to yields and increase borrowing costs for those states under pressure. Although credit for most states has not deteriorated over the past six months, an uptick in negative headlines is weighing on the markets. We continue to view the following states as "problems": California, Arizona, Illinois, Nevada, Michigan, Rhode Island, Florida, and Puerto Rico.

In 2010, there was a focus on austerity plans within Europe and the U.K. There will likely be a similar focus on what U.S. states need to do in order to get their fiscal houses in order. Many states will need to address their deficits and not just push the problem into the future. Although unpopular with some constituents, New Jersey Governor Chris Christie has set a good example, as he continues to make cuts to trim his state's multi-billion dollar deficit. Actions like this need to be taken across many if not all states.

Parting Thoughts

For most of 2010, it was a one-way ride in both rates (lower) and credit market returns (higher). Mixed economic data, lingering European debt concerns, and uncertainty around Fed policy were some of the key drivers. We feel it is important for the shift to occur from a bifurcated economy in which only large companies can borrow to one that provides equal support to everyone on a lending, borrowing and regulatory front. This is an ongoing process and is slowly working through the system.

Our fixed-income outlook for 2011 warrants a cautious view. We will remain patient, looking for attractive opportunities to add to our portfolios. Broadly speaking, we look to underweight the Treasury sector but are still positive with regard to Treasury Inflation Protected Securities (TIPS), as the backdrop is being set for future inflation. We are positive toward investment-grade corporate debt and neutral on agency spreads. Diversification and risk management, as well as the ability to remain nimble, will play very important roles in 2011.

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