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U.S. Inflation—Not a Serious Threat

By: SEI Investment Management Unit

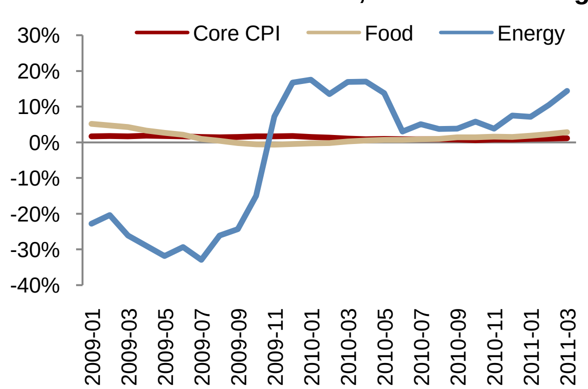
- While inflation is a problem in many emerging markets, and the bane of U.S. consumers, SEI does not expect it to stall the moderate, ongoing U.S. expansion.
- Rising food and energy prices are pushing headline inflation numbers higher, but overall core inflation remains well within the Federal Reserve (Fed)'s comfort zone.
- With unemployment high and industrial capacity utilization low, the Fed is unlikely to raise rates soon; when it does, it's unlikely to hike them sharply.

Inflation is the topic on everyone's mind. In the United States, a visit to the gas station is enough to cause most people to worry. In emerging-market countries, the rising cost of food has resulted in significant geopolitical unrest. While the prospects of $5-per-gallon gasoline and $4-per-gallon milk aren't things we like to consider as consumers, as investors, SEI's portfolios managers don't view inflation as a major concern.

A Matter of Perspective

From a consumer's perspective, food and energy are highly visible necessities of life. When the cost for these items rises, it provides cause for concern. In the United States, rising energy costs are the primary worry. While the cost of groceries is also rising at a pace that is higher than the rate of core inflation (the core inflation calculation excludes food and energy prices), it pales in comparison to the increase in the price of energy. Exhibit 1 highlights the pace of price increases through March 31, 2011.

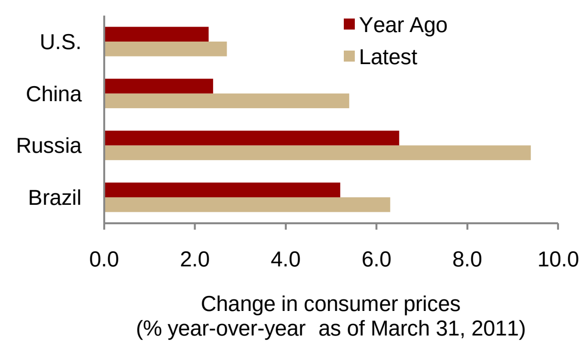
Exhibit 1: U.S. Core Inflation, Food and Energy



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

Overseas, inflation is an even more notable concern. While a general increase in prices hurts consumers in developed countries, the rising cost of food is particularly alarming in developing countries, as food accounts for a disproportionately high percentage of household income.

Exhibit 2: Consumer Prices in Select Countries



Source: The Economist

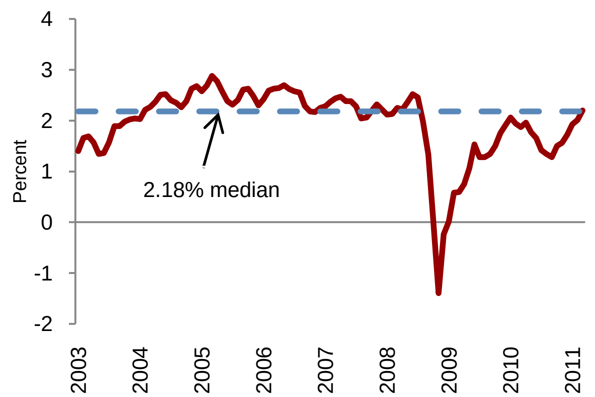
In response to inflation concerns, emerging nations have raised interest rates and taken other steps in an effort to curb growth. China, for example, has instituted limitations on real estate purchases to curb speculation and limit price increases. Among developed countries, the European Central Bank has begun a cycle of interest rate increases in an effort to halt inflation, while members of the Bank of England's Monetary Policy Committee (a minority, but a growing one) have voted for interest rate hikes.

The United States is the exception to the rule, as the Fed's policy-setting committee[1] remains unanimously in favor of holding the Fed's interest-rate target at today's historically low level. The Fed

[1] The Federal Reserve Open Market Committee (FOMC)

looks at inflation from a different perspective than most consumers. There are two key aspects of the Fed's analysis that must be taken into consideration. The first is that the Fed tends to put less weight on more volatile goods such as food and energy in its calculations. The second is that the Fed focuses on longer-term inflation indicators, such as the five-year breakeven inflation[2] rate, which currently remain benign (Exhibit 3).

Exhibit 3: Five-Year Inflation Expectation

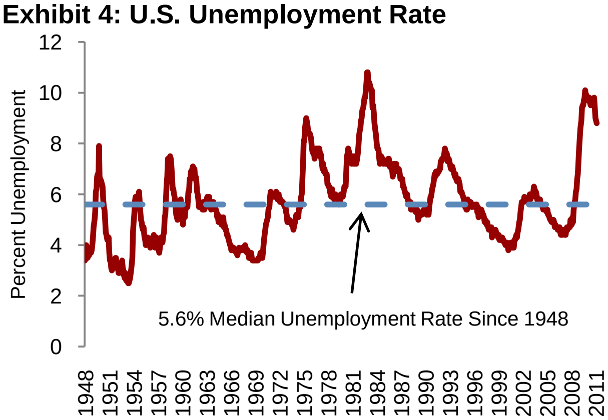


Source: Federal Reserve Bank of St. Louis

Households—A Major Piece of the Puzzle

There is always some risk that rising food and energy prices will feed into other prices permanently, as they did in the 1970s. But today's economic backdrop does not argue for such an outcome. As of March, unemployment remained just under 9% (Exhibit 4), and the housing market remains mired in a cycle of falling or stagnant prices against a background of rising foreclosures.

Exhibit 4: U.S. Unemployment Rate



Source: Department of Labor: Bureau of Labor Statistics

[2] A breakeven rate is the difference between a nominal and a real (inflation-adjusted) yield. The current five-year breakeven inflation rate is obtained by subtracting the current yield on a five-year Treasury Inflation-Protected Security (TIPS) from the current yield on a five-year nominal Treasury security.

While the unemployment rate has not quite reached its highs of the early 1980s, the current duration of unemployment is nearly three times its long-term average, while the total percentage of un- and under-employed (the Bureau of Labor Statistics' U6 measure) is 67% higher than its long-term median value.

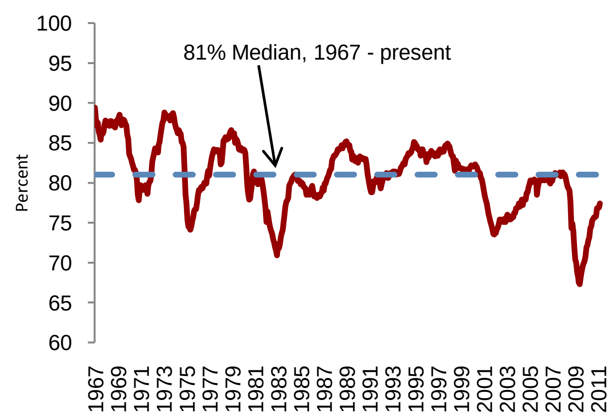
As a result of this significant and ongoing slack in the labor market, it's highly unlikely that U.S. households will be able to absorb significant increases in food and energy prices without cutting back on their consumption elsewhere. In short, people who are out of work or concerned about losing their homes generally don't spend money in the volumes necessary to demonstrate rising consumer demand and foster inflation.

As a result, while higher commodity prices are undoubtedly changing expenditure patterns, they are unlikely to lead to a general rise in prices unless the picture for U.S. household employment and income improves dramatically.

More Puzzle Pieces

There's also plenty of slack in terms of industrial capacity utilization. As Exhibit 5 shows, utilization has partially recovered, but remains well below long-term levels (in fact, it's been at or below its historic median since the 2001 recession).

Exhibit 5: U.S. Total Industry Capacity Utilization

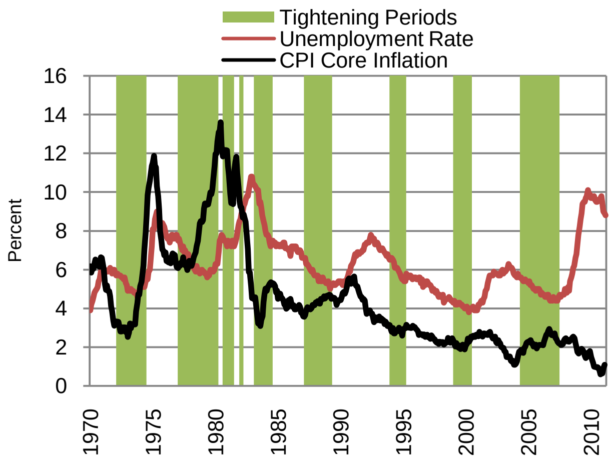


Source: Federal Reserve Bank of St. Louis

These negative employment and capacity dynamics are captured well in Exhibit 6 on the following page, which shows just how wide the gap between high unemployment and low inflation is today. One of investors' primary concerns with inflation is that it usually motivates central banks to tighten monetary policy and thus limit the flow of credit. However, if Exhibit 6 is any indication, the Fed is not likely to begin raising its interest rate target until the gap between unemployment and inflation has retreated meaningfully from today's historic level.

Thus, despite the pain that higher food and gas prices are causing for households, we do not believe that inflation—in the traditional sense of a rise in the overall price level—is a serious threat to investors or the economy at this time.

Exhibit 6: Unemployment, Inflation and the Fed



Source: Bureau of Labor Services, U.S. Federal Reserve

What If Inflation Does Happen?

Despite the lack of an imminent threat, it's important for investors to have an idea of what rising inflation expectations could mean for their portfolios. To accomplish this, SEI's Risk Management Group recently carried out stress tests across asset classes, SEI Funds and SEI Strategies. If broad inflation expectations and interest rates were to rise significantly, we would expect to see the following effects: total returns from equities would decline moderately, the U.S. dollar would strengthen against other currencies, and overall market volatility would increase.

Equity Performance

Equity holdings denominated in currencies other than the U.S. dollar would likely underperform.

In our Funds, SIIT Small Cap experienced the largest decline in our test due to its high sensitivity to stock market momentum. Relative performance was helped in those Funds that are underweight foreign currency exposures, especially the Australian dollar, British pound, Canadian dollar and Japanese yen. The International Equity and World Equity ex-US Funds enjoyed favorable relative performance thanks to underweight exposures to foreign currencies and certain countries.

Fixed-Income Performance

As expected, fixed-income securities were negatively impacted by rising inflation expectations.

Short-duration positioning helped relative performance, while exposure to corporate issuers in our core Funds had a negative impact as spreads would be expected to widen. Underweight positions in foreign currency and overweight positions in the U.S. dollar helped the relative performance of Funds holding non-U.S. securities.

Stress Test Conclusions

On a relative basis, a fund is most likely to be negatively impacted by rising inflation if it has above-benchmark exposure to foreign currencies, equity market momentum or fixed-income duration and spread. Of course, investors should keep in mind that these findings are based upon a snapshot of current fund holdings. As a fund's exposures change, its sensitivity to inflation and expected performance could be affected significantly.

Our View

In our fixed-income Funds, our macro-oriented managers see inflation on the increase. One of them (Western) views inflation as a slowly unfolding process that will present some tactical opportunities but does not necessitate a short-duration strategy. The other (Metropolitan West) views inflation as a serious concern and is taking short-duration strategic positions as a result. At SEI, we expect long-term rates such as the 30-year U.S. Treasury bond to remain relatively range-bound, with the largest interest rate increases occurring in short- and intermediate-term maturities as the yield curve flattens. If inflation becomes a more pressing concern, our managers will address it through short-duration and yield-curve positioning (it should be noted that our managers are already short-duration relative to fund benchmarks).

Our Fixed-Income Funds

Overall, our managers continue to see more attractive opportunities in non-Treasury sectors of the market, such as corporate and high yield debt, agency- and non-agency-backed mortgage securities, and bank loans. In an inflationary environment, these should offer a more favorable risk and reward tradeoff than the benchmark. As a result, we believe the Funds are well-positioned for what we expect will be a long and occasionally volatile interest-rate cycle. It's also important to remember that, although inflation and higher interest rates will push the market values of many of our

Funds' securities lower, those underlying holdings (barring default) will generate recurring cash flows that should help moderate declines in market value.

Finally, although our stress-testing indicates that a rise in inflation expectations may have a negligible impact on commodities, we believe the Fed's next rate-hiking cycle could have a negative impact on certain commodities such as gold, which tend to benefit from periods of low interest rates. That being said, we expect the next interest-rate cycle to unfold very gradually relative to prior episodes. For example, in 1994, the Fed hiked rates sharply in response to an economic recovery that was taking hold against a backdrop of high capacity utilization and tight labor markets. In 1983-84, the Fed hiked rates to double-digit levels despite high unemployment, due to widespread fear of a return to the high inflation rates of the 1970s. Today, capacity utilization is low, unemployment remains high and the threat of double-digit inflation is remote.

Our Equity Funds

In our equity Funds, nearly all of our managers analyze securities on a fundamental, company-specific basis. Should inflation become a more pressing concern, they are likely to find more perceived value in companies that can perform well in such an environment. Factors that play a role in this include a firm's sector, industry, geographic makeup of sales and operations, fixed-versus-variable costs, internal financing activities, etc. Managers would be likely to lower exposure to those sectors, industries and companies that, for example, benefit from low interest rates and a steep yield curve or have difficulty passing higher input costs on to customers. Likewise, they would tend to favor those that have pricing power or provide products and services that help other businesses manage inflation-related risks, such as IT software and services.

Our Portfolios

Our Portfolio Strategies Group has taken proactive steps to prepare for current and expected market conditions, including potentially inflationary outcomes. These preparations include changes that result in our portfolios being:

- Underweight to fixed-income
- Overweight to equities
- Underweight duration[3]
- Overweight high-yield

These allocation tilts are designed to benefit from our forecast of an ongoing but moderate and volatile economic recovery. As a result, they should also reduce the portfolios' overall sensitivities to higher inflation expectations and rising interest rates, should either of those conditions occur.

[3] Duration is an estimate of the change in a security's or a 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.