

## Commentary

## Muddling Through After the Debt Ceiling Debate

By: SEI Investment Management Unit

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- After months of political wrangling, a deal has been reached to raise the U.S. debt ceiling.
- Few are happy with the results, and long-term measures to address the debt must still be implemented.
- While a debt-rating downgrade is still a very real possibility, the financial markets have already moved beyond the spectacle of the debate and are reacting to the host of indicators signaling a potential economic slowdown.
- Despite the economic woes, we remain firmly in the camp of those who anticipate continued market advances.
- We view any market pullbacks as opportunities to add to equity exposures using assets currently invested in U.S. Treasuries or investment-grade securities as a source of funding.

The U.S. government has approved a last-minute deal to keep the country from going into default. Despite the compromise deal that pleased few and angered many, credit-rating agencies may still downgrade their ratings on U.S. sovereign debt (one has moved to a negative outlook while affirming the current AAA rating). While a downgrade should not have a meaningful impact on the value or performance of U.S. Treasuries, it will be disruptive. What it will not do is put an end to the global trading in U.S. sovereign debt. The math is simple: the United States issues nearly 60% of the world's AAA-rated debt. China, the world's next-largest economy, is not a factor in this market. Japan, the world's third-largest economy, has already seen its sovereign debt downgraded to AA status. Among nations issuing AAA-rated debt, Germany ranks second to the U.S. with 10% of the world's supply. For better or for worse, there is simply not enough AAA-rated debt available in the marketplace, making debt from the U.S. one of the highest-quality choices available even if it holds only a rating of AA. While a downgrade will cause some headaches for the banking system, the financial markets have already moved beyond the debt ceiling debate to focus on the nation's economic health, and the picture is not pretty.

### The Economic Outlook

Bad news seems to be everywhere these days, affecting a majority of the drivers of economic growth.

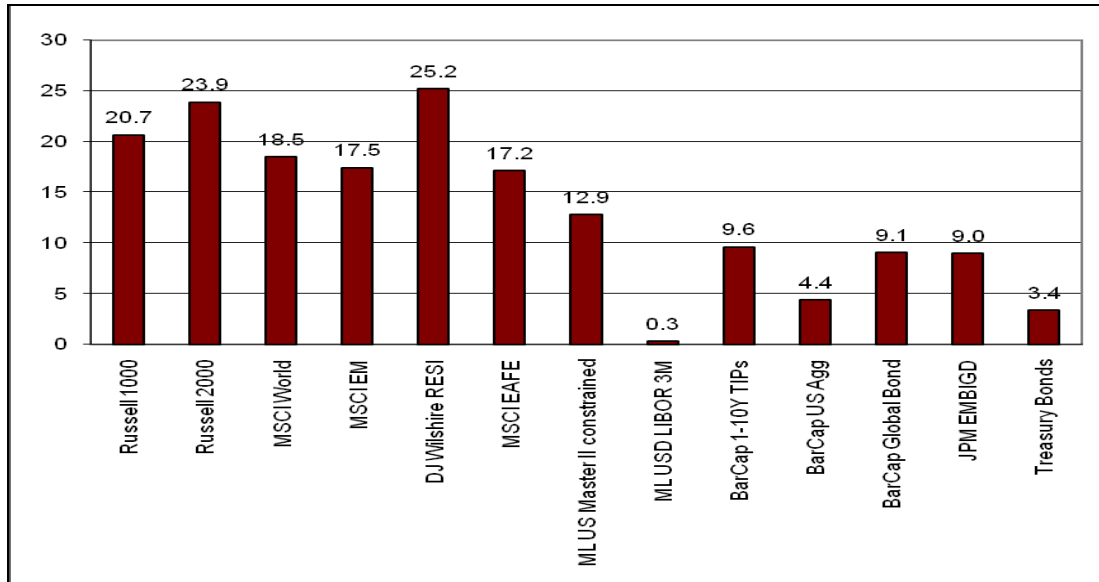
- The housing market remains mired in the price collapse that took place a couple of years ago, and it has a long way to go toward recovery.
- In the labor market, jobs are still hard to come by for many Americans as unemployment hovers just below double digits.
- The continued negativity in all of these areas has spilled over to the consumer as well.
- The gloom and doom is also reflected in our current political atmosphere.
- In the corporate sector, money remains on the sidelines as firms neither invest nor hire. If you add in the uncertainties surrounding the European sovereign debt crisis, the general lack of confidence takes on a global flavor.
- In the meantime, fears of a return to recession and the murkiness of what may or may not come to pass has created volatility in the financial markets.

Welcome to the summer of 2011? Yes and No. The "Economic Outlook" expressed above reflects words we wrote in a commentary released during the first week of August of 2010 when weak economic data and a struggling economy had raised fears of a double-dip recession to a feverish pitch. One year later, we find ourselves in a similar place as market prognosticators look to slowing economic indicators as a sign that descent into recession is inevitable. The scenario reflects market conditions at this same time last year. What have we seen since then? The numbers tell the story.

## Markets Advance

Since last year's dire predictions of a double-dip recession, the U.S. economy has continued to grow, albeit slowly. U.S. and global markets have also moved ahead. It has not been a smooth ride and it has not felt good, but the results are undeniable. Major global stock and bond markets have posted significant gains, as shown in Exhibit 1. By contrast, consumers have taken a beating with lingering unemployment and a stalled housing market adding to their troubles.

**Exhibit 1: Global Markets Rally (12-month returns as of 7/31/11)**



## Our View

Just as the economic concerns facing the global economy remain largely the same as those we faced this time last year, the underlying fundamentals that drive the stock market also remain the same. Solid companies are trading at reasonable valuation levels. Corporate results have been mostly positive, with revenues and profits rising at a double-digit pace. Companies are sitting on record levels of cash (Apple had more money on hand last week than the U.S. government). Global monetary policy remains largely accommodative (despite the end of quantitative easing efforts in the U.S.).

On the recession front, inflation remains in check, and the U.S. yield curve remains steep—every recession in the post-World War II era has been accompanied by a flat or inverted yield curve. Similarly, the beginning of a bear market is often marked by rising corporate valuations, rising interest rates and rising consumer debt levels. None of those are currently present.

In summary, corporations are in good shape even if the economy is not. Even with its troubles, the economy continues to grow, muddling slowly ahead despite the bad news. While the U.S. debt problem still needs to be addressed and the global economy continues to see headwinds, we expect to see the markets continue to move slowly forward.

## Active Management

At SEI, we believe in active management and proactive planning. Our funds are generally managed with a long-term perspective. However, we recognize that short-term market events can present opportunities for tactical investors. At the present time, SEI favors an overweight in equities (emphasizing U.S. large-company stocks) versus investment-grade debt. While this bet lost ground during the second quarter, we are confident that stocks will rebound relative to bonds. We also favor corporate debt over sovereign debt and high-yield bonds over investment grade. This is consistent with our view that the corporate sectors in the U.S. and other developed economies are in strong competitive positions. Regionally, we favor a tilt toward U.S. equity versus Europe and Japan owing to our view that the U.S. is the structurally sounder market despite the country's debt burden.

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