SEI New ways. New answers.®

January 2012

Fourth Quarter 2011: Economic Outlook

A Pivotal Year Ahead

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

There is no denying that the past year was a trying one for investors. Global equity markets were mostly lower. Global bond markets saw extreme volatility, with the debt of a few select countries (the U.S., Germany, the U.K. and Canada, to mention the most important ones) registering the only healthy returns in an investment environment that swung from risk-on to risk-off with unnerving frequency and ferocity.

There is, however, no rest for the weary. Global financial markets remain fragile and subject to sharp moves based on the latest headlines. With Europe on the cusp of recession, China laboring through the downside of a property bubble, and the U.S. heading towards its most important election cycle in decades, there will be no quick end to the uncertainty that has made investing a difficult enterprise.

By this time next year, some of the most important questions facing investors will be resolved or on their way to a resolution. France will hold key elections in May, and in the U.S. investors will know by November who will be occupying the White House and the two chambers of Congress in 2013. A more durable solution to the European debt crisis will likely be in place. And another year of financial deleveraging will have been achieved in the developed world. All these events should help reduce the uncertainty that has hurt investor and consumer confidence and depressed economic growth in recent years. Given the generally compressed valuations of riskier assets in the market-place, there's the possibility of a surprisingly strong end to the coming year. Despite that, the advice given by Margo Channing (played by Bette Davis) in *All About Eve* (1950) might prove useful: "Fasten your seatbelts, it's going to be a bumpy ride."

Europe on the Ropes

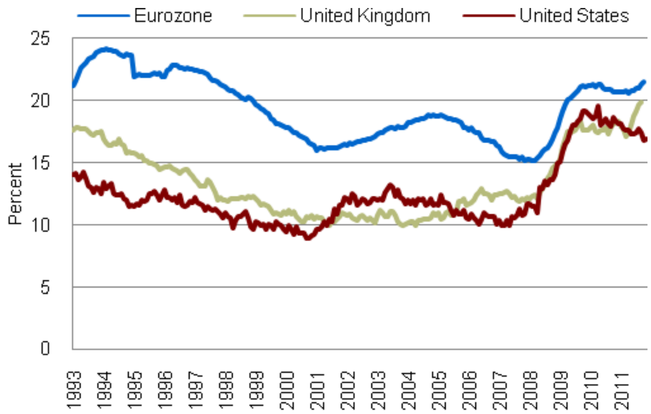
In a world of hurt, Europe seems to be hurting most. Economic indicators there have taken a turn for the worse in recent months. Countries that use the euro as their national currency are seeing signs of outright recession. Purchasing manager surveys, for example, have fallen sharply to levels that are normally associated with a severe contraction in economic activity. On a country-by-country basis within the eurozone, only Germany's composite purchasing manager indices are above the recession line. But even the strongman of Europe seems headed for a notable slowing in its rate of economic growth.

We acknowledge that business sentiment surveys have their flaws, but they are currently supported by the weight of the economic evidence. Retail sales in the eurozone, measured on a year-over-year basis, have been in negative territory for several months. Labor-market indicators have deteriorated as well, with the number of unemployed rising for six consecutive months through October, and the eurozone unemployment rate rising to 10.3%, the highest level since June 1998.

A Generation Without a Place

Most worrisome is the sharp rise in the unemployment rate of younger workers (24 years old and younger). At 21.4%, Europe's youth unemployment is more than twice the eurozone's overall average. As Exhibit 1 on the next page shows, this has become a critical issue in the developed world as a whole since the onset of the 2007-2009 recession (the U.K. has shown a particularly steep rise since mid-2011), and youth unemployment has been a structural problem for the Continent for a long time.

Exhibit 1: Youth Unemployment



Sources: Bureau Labor Statistics (U.S.), Eurostat, Office of National Statistics (U.K.), SEI

With the deepening of the financial crisis in Europe, the problem has gotten far worse. Youth unemployment has risen to an astounding 48.9% in Spain, and Greece is not far behind at 45.1%. Given the fact that nearly half of the younger population cannot find jobs in these countries, it is obvious that widespread labor-market reform is essential above and beyond a return to more normal economic growth. The absence of such reform, within the context of recession and long-term austerity, could create wider social problems in developed countries than those we have already seen.

European Road Trip: Are We There Yet?

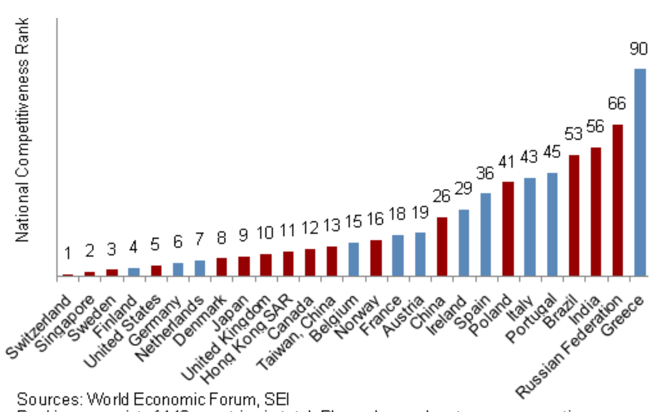
As recession clouds gather and unemployment rises from levels already viewed as intolerable, Europe's search for a solution to its debt crisis has become more desperate. Despite the desperation, the latest "comprehensive" agreement, like the ones before it, appears to be a day late and a euro short (see SEI's December 2011 commentary, "The European Union's 'Fiscal Compact'—More of the Same"). Although a great deal of attention has been paid to the United Kingdom's veto to any EU treaty change, there was no reason to believe that a unanimous agreement among all 27 members of the European Union would result in a complete and satisfactory solution to the crisis that has enveloped the eurozone for the past two years.

SEI has steadfastly believed from the start that any attempt to resolve the crisis, short of full fiscal union, a massive transfer of aid, and socialization of national governments' debt through the issuance of eurobonds was likely to fail. The weakest members of the eurozone are simply too indebted and uncompetitive. Germany's insistence that the periphery debtors deflate their way to health is reminiscent of the 18th century practice of throwing a person into debtors' prison until he has worked off his obligations. By the same token, one can sympathize with the Germans' hard-nosed stance. The debtors of the periphery got themselves into this mess.

If anyone knows the costs of setting things right, it would be German taxpayers, who footed the bill for reunification between East and West Germany. Between 1990 and 2010, the six former East German states received €1.3 trillion ($1.69 trillion) in government reconstruction payments under the so-called Solidarity Pact, according to the Halle-based IWH Research Institute. The pact, which is scheduled to expire in 2019, continues to cost some €80 billion per year. At the time of unification, East Germany's productive capacity was only about one-third that of West Germany, while today it is approximately 70%.

In Exhibit 2, we highlight a chart we first showed in early 2009, noting the competitive rankings of various countries as judged by the World Economic Forum (WEF), a non-profit foundation best known for its annual meetings in Davos, Switzerland. These global rankings are based on the WEF's 12 pillars of competitiveness,[1] providing a comprehensive picture of the competitive landscapes in countries around the world at all stages of development.

Exhibit 2: Greece Reaps the Bitter Fruits Austerity



Sources: World Economic Forum, SEI
Rankings consist of 142 countries in total. Blue columns denote eurozone nations.

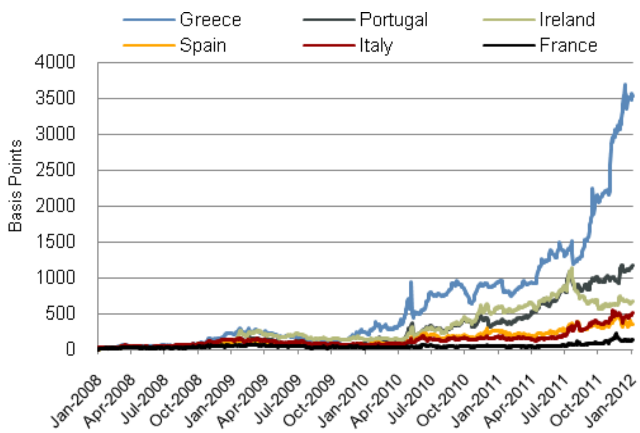
Two years ago, Greece ranked 71 out of the 133 nations surveyed. In the latest rankings, the country has dropped to 90 out of 142 nations. Despite nearly two years of additional austerity and a sharp deterioration in living standards, Greece has slipped substantially in competitiveness and is now positioned, for example, behind Lebanon and just ahead of El Salvador. According to the WEF, Greece's inefficient government bureaucracy is by far the biggest impediment facing businesses in the country. Corruption, tax regulations, policy instability and access to financing

[1] "The Global Competitiveness Report 2011-2012," World Economic Forum, Davos, Switzerland, 2011, p. 13. The 12 pillars include Institutions, Infrastructure, Macroeconomic Stability, Health and Primary Education, Higher Education and Training, Goods Market Efficiency, Labor Market Efficiency, Financial Market Sophistication, Technological Readiness, Market Size, Business Sophistication and Innovation.

also rank high as obstacles to improving competitiveness. Of the major pillars behind the WEF's analysis, it should be noted that Greece ranks 140 in terms of Macroeconomic Stability. It's hard to imagine how things could get worse, but as long as the country is forced to deflate its cost structure within the debtors' prison of the single currency, they probably will.

Although Greece is the extreme outlier, the other problem debtors of the eurozone—Portugal (ranked 45), Italy (43), Spain (36) and Ireland (29)—are still significantly behind the eurozone's most competitive nations—Finland, Germany and the Netherlands—which are all in the world's top ten. As shown in Exhibit 3, this gap in competitiveness correlates well with the way fixed-income investors judge the benchmark bonds of these countries. Although yields have moved away from their panic highs for Italy and Spain, it is clear that the market remains unconvinced that Greece will remain part of the European Monetary Union.

Exhibit 3: Ten-Year Government Bond Yields



Source: Reuter's/Datastream, national sources
One basis point equals 0.01%; 100 basis points equals one percent.

In SEI's view, the odds favor an eventual departure by Greece from the eurozone. The questions are when that will happen and how it will be done. Meanwhile, we believe the leaders of Europe are simply playing for time in order to make the transition as orderly as possible and prevent a contagion effect. We think it is reasonable to assume that European policymakers will do all they can to create a firewall that protects Italy and Spain. The recent agreement to: (1) bolster the European Financial Stability Facility (EFSF); (2) bring forward the starting date of the European Stability Mechanism (ESM, the permanent bail-out fund); and (3) contribute €150 billion to the International Monetary Fund's (IMF) general fund in order to get around the European Community's Treaty commitment against the direct bail-out of member states, will theoretically protect the government debt of Italy and Spain for up to the next three years if those countries' governments prove unable to fund themselves through normal market channels. Of course, the devil is in the details, and the lack of detail in the latest agreement may explain why investors remain so unimpressed.

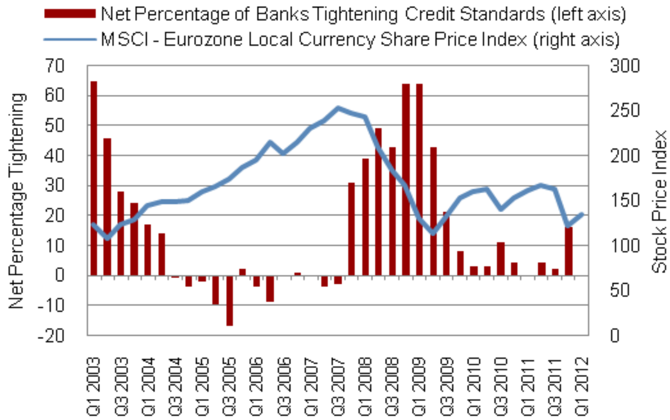
An additional element of any solution to the European debt crisis is the recapitalization of the banking system. Here, too, some progress has been made. New stress tests have been conducted, indicating some €115 billion in new capital must be raised by mid-year 2012 for banks to achieve a Tier 1 capital ratio of 9%. The good news is that, historically, the announcement of a credible recapitalization plan is the first step toward the resolution of a financial crisis. Although much more work needs to be done—in fact, we suspect the total recapitalization of the European banking system will be significantly higher when all is said and done—equity markets have tended to rally in the years following such announcements. Stock prices more than doubled following the recapitalization announcements by Sweden in 1992 and by Korea, Malaysia and Thailand following the 1998 Asian Contagion. Bank recapitalizations in Japan in 1999 and the U.S. and U.K. in 2008 were followed by smaller yet still-substantial equity-price recoveries over the following year.[2]

There are also downside risks, however. Banks' efforts to improve their Tier 1 capital ratios will also entail a reduction in assets, including loans and investments. This is almost certain to exacerbate the credit squeeze that has already hit Europe's corporate sector, which is more dependent than its U.S. counterpart on banking relationships. Lending standards in Europe tightened sharply in the past quarter, the steepest rise since the bottom of the recession in 2009. Given Europe's troubles in recent months, it would not be surprising to see another sharp tightening in credit standards when the next quarterly survey is released.

As Exhibit 4 on the following page shows, equity markets tend to struggle when financing conditions become more difficult. However, Exhibit 4 also shows that equity markets tend to rise when lending standards ease. Thus, we may encounter a terrific buying opportunity in European stocks in the months ahead. That being noted, we'd rather play it safe and see how the latest "comprehensive solution" evolves.

[2] "Bank Recapitalizations—The Bell Tolls?" Empirical Research Partners, Global Portfolio Strategy, October 12, 2011.

Exhibit 4: Brother, Can You Spare a Euro?

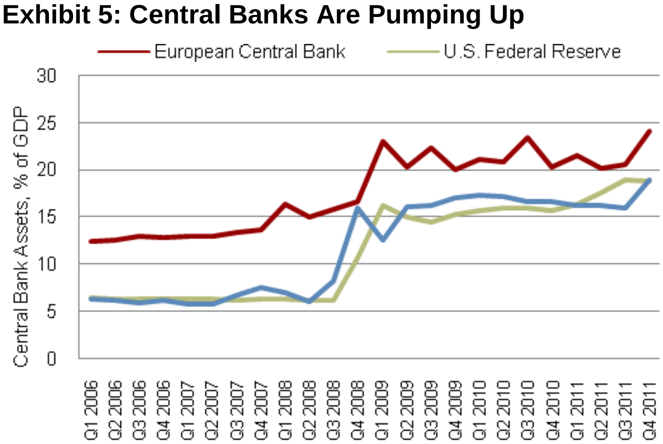


Sources: European Central Bank, MSCI, SEI

'Expanding' the ECB's Role

Finally, we need to examine the role of the European Central Bank (ECB). Under Mario Draghi, the new ECB president, policy rates have fallen one-half of a percentage point, fully reversing the ill-advised increases that occurred in April and July 2011. In 2012, SEI forecasts additional interest-rate cuts as the ECB leans against the recessionary pressures now building in the eurozone. Indeed, the adoption of a zero-interest-rate policy (ZIRP) is a possibility, since the ECB wants to avoid engaging in Fed-style quantitative easing as long as possible. That said, the ECB's balance sheet expanded sharply during the second half of 2011 as it engaged in emergency lending to banks (see Exhibit 5). This expansion is another big positive for Europe, since it reduces the possibility of a liquidity crisis within the banking system. By agreeing to lend to banks for as far out as three years at a low rate of interest with loose collateral requirements, the ECB is helping banks improve the quality of their balance sheets and expand their net interest margins.

Exhibit 5: Central Banks Are Pumping Up



Sources: Bank of England, European Central Bank, Federal Reserve

The implementation of a ZIRP could also be the catalyst that finally weakens the euro, which ended the year modestly lower against the dollar ($1.29) from where it began. The relative strength of the currency during the first half of the year, when it reached a peak of nearly $1.50, was one of the bigger surprises relative to our expectations for 2011. As the ECB continues to lower its lending rate while the eurozone threatens to sink into recession, we expect the currency to stay on the defensive through 2012, perhaps falling as low as $1.20 sometime in the next 12 months.

U.S. in a (Volatile) Holding Pattern

It has been a year of deep frustration in the U.S., politically, economically and financially. Things seemed to get off to a good start, with economists raising their forecasts for economic growth. Unfortunately, the black swans soon started flying. The surge in energy prices in February, associated with the onset of the Arab Spring throughout the Middle East, was the first negative surprise. This was soon followed by the Japanese earthquake/tsunami/nuclear plant meltdown and the civil war in Libya. The U.S. and global economies lost momentum and expectations plunged, as worries of a double-dip recession reappeared for the second year in a row. A series of fumbling policy maneuvers in Europe, along with a bitter showdown over the U.S. government's debt ceiling in July (including a near-shutdown of the federal government), followed by the downgrading of the U.S. government's credit rating by Standard and Poor's, proved toxic for financial markets. Despite the fireworks, the U.S. economy continued to muddle through as we expected.

A Look Back at 2011

Looking back one year ago, we were mostly right to expect moderate economic growth, driven by a recovery in household consumption and solid gains in business fixed investment. The U.S. has certainly shown a dogged resiliency in the face of oil spikes, natural disasters and feckless politicians. We also thought that core inflation would remain subdued (that is, below 2%) despite a further rise in commodity prices, and that the federal funds rate (the Federal Reserve's targeted rate for interbank lending) would stay unchanged through the year.

However, we did not anticipate the price volatility exhibited by markets, the plunge in consumer, business and investor confidence levels, or the extreme risk aversion displayed by investors in the July to September period. Although SEI correctly predicted that the U.S. stock market would be one of the better global performers, particularly against European bourses, we were too optimistic in anticipating a move back toward the 2007 highs.

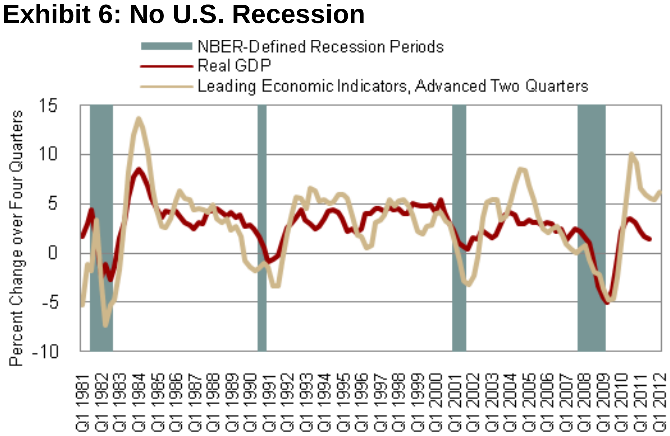
Our expectation that the Obama Administration and U.S. Congress would act responsibly in a bipartisan manner for the good of the country may have been our biggest mistake, as political acrimony and gamesmanship were the norm. This, along with Europe's ongoing saga, compounded the aforementioned events and disasters and severely affected investors' psyches. The resulting waterfall decline in equities in late July and early August, and the equally stunning drop in ten-year U.S. Treasury yields from 3% to an eventual low of 1.8% in October, were far from our baseline assumptions for 2011.

Although we underestimated how badly markets would react in late summer, we did manage to salvage some of our dignity in anticipating the October snap-back in equities (see SEI's October 2011 Economic Outlook, "Blood in the Streets: Time to Buy").

Looking Ahead—Mostly Positive

Exhibit 6 compares the Conference Board's Composite Index of Leading Economic Indicators (LEI) to the change in real (inflation-adjusted) gross domestic product (GDP). The LEI series, which is advanced by two quarters in light of its predictive nature, seems to point to an accelerating pace of business activity as the U.S. heads into 2012. Strong percentage moves in the LEI do not typically translate into similarly-sized changes in real GDP, but we can still be fairly confident that the U.S. economy will continue to expand at a moderate pace over the next six months, and more likely than not, over the entirety of 2012.

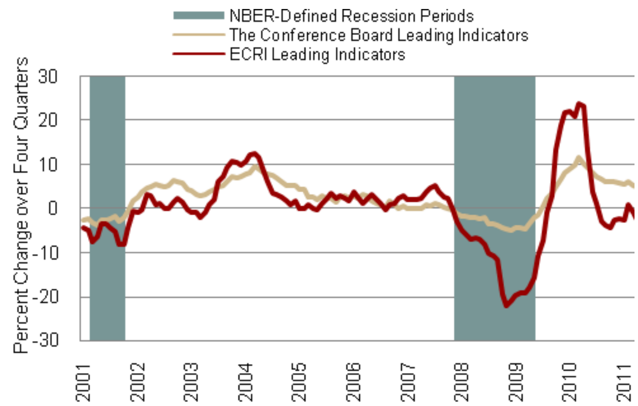
Exhibit 6: No U.S. Recession



Sources: Bureau of Economic Analysis, The Conference Board, National Bureau of Economic Research, SEI

Of course, nothing goes unchallenged these days. Another set of leading indicators we follow, published by the well-respected Economic Cycle Research Institute, (ECRI) has been far weaker and more indicative of a developing U.S. recession, as shown in Exhibit 7.

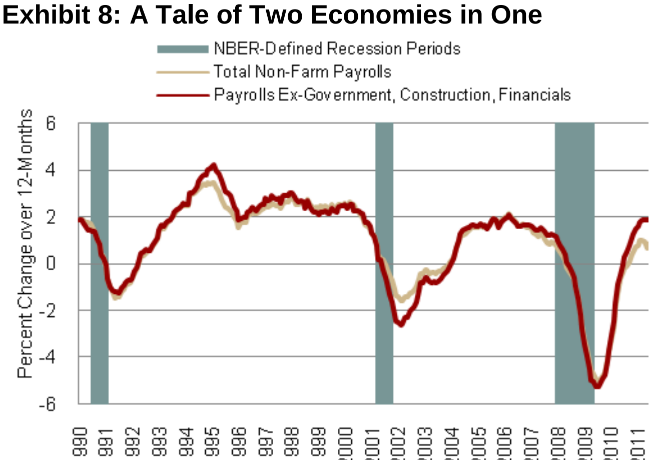
Exhibit 7: Follow The Leader—But Which One?



Sources: Economic Cycle Research Institute, The Conference Board, The National Bureau of Economic Research, SEI

The bulk of the evidence, though, still seems to point toward a more positive outcome than the ECRI data currently suggest. Labor-market measures, such as payrolls and initial claims for state unemployment insurance, strongly hint at modest improvement despite the uncertain business environment. Exhibit 8 reveals that the bulk of the labor market is now growing at a more normal-looking 2% annual pace. In contrast, sectors that were at the center of the mortgage-related debt boom-and-bust have lagged behind for the past three years. For example, the construction, finance and government sectors of the U.S. economy, which account for some 35 million workers (or 27% of total non-farm payrolls), have recorded a rise of just 1.2% over the past year and are still 2% below the level recorded at the recession's bottom in June 2009.

Exhibit 8: A Tale of Two Economies in One



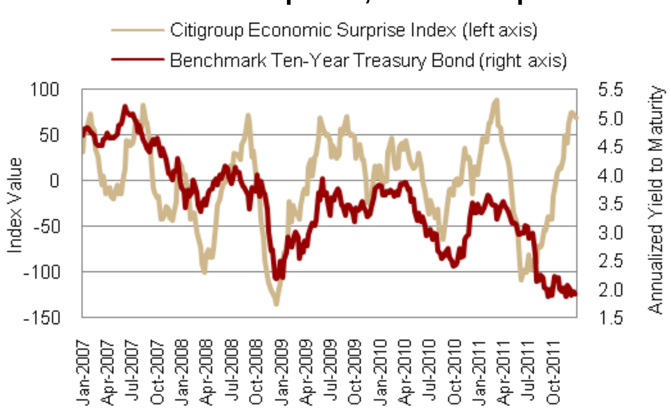
Sources: Bureau of Labor Statistics, National Bureau of Economic Research, SEI

Unfortunately, all three sectors will continue to act as a drag on the overall economy as the debt-deleveraging process follows its multi-year course. State and local governments will be squeezed even harder this year as federal stimulus payments fade away (although the majority of states now are recording improvement in their tax revenues, reflecting the better tone of the economy in recent quarters, as well as the imposition of tax hikes and higher user fees). Meanwhile, federal government payrolls are likely to remain stable until Washington finally applies fiscal discipline in 2013 and beyond. Within the financial sector, the ongoing woes of the larger banks and the strictures placed on various proprietary activities by the Dodd-Frank legislation will almost certainly hamstring the industry's recovery. Finally, construction employment remains moribund, but has at least stopped declining after a drop of almost 30% from the 2006 peak. We think it will take another two years to work through the housing inventory overhang. Until new construction kicks into a higher gear, payroll growth will remain constrained and unemployment is unlikely to dip below 8%.

Positive Surprises, Bond Markets Unmoved

Sluggish employment growth notwithstanding, the U.S. economy has been on an upswing according to the most recent data. Judging by the reactions of financial markets though, investors remain quite skeptical about the sustainability of the advance. Exhibit 9 tracks Citigroup's Economic Surprise Index (ESI) for the U.S. against the yield on benchmark 10-year U.S. Treasurys. The bad news seemed to reach a peak during the summer, concurrent with the stock market's swoon. Since then, the ESI has entered positive territory and is approaching its previous high-water marks. Unlike earlier episodes of improvement in the ESI, Treasury yields have failed to move higher in tandem with the improving news flow, and remain at historic lows.

Exhibit 9: Positive Surprises, Minimal Impact



Sources: Citigroup, Federal Reserve Board, SEI
Index values greater (less) than zero indicate that reported economic data is surpassing (falling short of) consensus expectations.

There are several possible causes for this notable break in the historic relationship between the ESI and Treasury yields. Investors may fear that the modest but ongoing expansion in the U.S. could be snuffed out by problems in Europe or elsewhere in the world. The Fed's aggressive purchases of longer-dated Treasuries (known as Operation Twist) could also be having a yield-dampening impact.

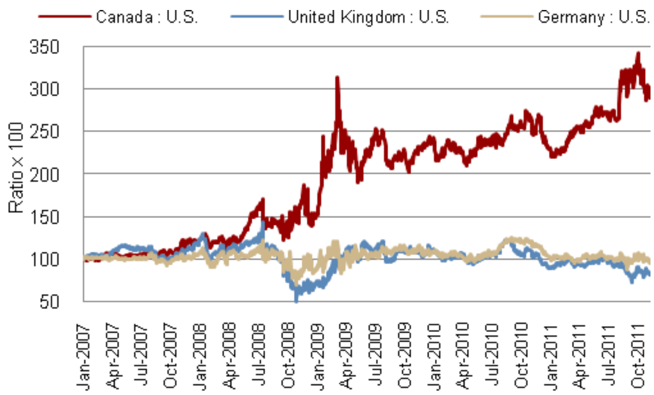
In the near term, it appears that U.S. financial markets will be held hostage to the latest developments in Europe. Bond yields in the U.S. are lower than we think they should be given general economic conditions, presumably as a result of investors having a greater-than-normal preference for safety and liquidity. If we were in a normal economic cycle, we think longer-term Treasury yields would be 3% or higher, reflecting the current resilience of the U.S. economy and the fact that core inflation appears steady at around a 1.5% to 2% annual rate.

Equities Buoyant, U.S. Banks Look Cheap

In contrast to the Treasury market, U.S. equities did respond positively to the improvement in economic fundamentals, posting one of their best-ever October performances before entering a new, higher trading range compared to the August to September period. The crucial and difficult-to-answer question is whether this trading range can hold—especially if the European sovereign debt crisis were to morph into a systemic banking crisis. It probably would be against the odds. Still, we want to underscore the fact that the U.S. economy is continuing its process of repair and rejuvenation. In addition, the U.S. banking system is in much better shape than Europe's—capital ratios are stronger, assets are generally priced more realistically on balance sheets, and the mortgage mess is slowly getting sorted out. In contrast to Europe, where assets are being sold to raise capital, the U.S. banking system's loans and investments expanded by almost 5% from the start of 2011 through October 31.

Investors in bank stocks have not discriminated between most banks, however. Over the past year, U.S. bank stocks have only slightly outperformed their counterparts in Germany and the U.K., and price return correlations have been over 90%. Canada is a stark exception, as its banks have enjoyed impressive share-price performance relative to U.S. bank stocks, beginning in 2008, as shown in Exhibit 10 on the following page. Unlike banks in many other countries, they didn't own significant amounts of problematic mortgages and related assets.

Exhibit 10: No Crisis in Canada



Source: Datastream, SEI
Vertical axis shows ratio of local currency bank stock index prices for Canada, Germany and the U.K. to a U.S. bank stock index (January 1, 2007 = 100).

By the same logic, U.S. direct exposure to troubled eurozone periphery debt is *de minimus,* and exposure to the debt of core eurozone countries has been reduced aggressively in recent months. In our opinion, investors may be too pessimistic about the U.S. banking system nowadays. Valuations appear statistically cheap on a price-to-tangible-book basis. If credit transmission channels are on the mend, and the economy remains on its modest growth track, the big surprise of 2012 could be a rebound in bank stocks (within the context of a positive overall trend in equity markets).

Politics Will Keep Investors Busy

More than ever, professional portfolio managers need to consider the macroeconomic background when allocating assets and selecting securities. Unfortunately, not only do they need to be economists nowadays, they also need to be political experts. The 2011 gridlock in Washington was a primary cause of the summer's market volatility, and it is a near-certainty that political considerations will remain a market-moving force in 2012.

Even as 2011 came to an end, the danger of a sharp fiscal squeeze amounting to some 2.3% of GDP weighed on markets. Although politicians in Washington managed to broker a last-minute (and very temporary, at two months) agreement to maintain the payroll tax break, extend income support for the long-term unemployed and take care of other matters needing a quick fix, partisan politics are hurting the country.

The November 2012 elections promise to be one of the most important events of the year for the global markets. The early odds favor a Republican takeover in the Senate, where only 10 Republican seats will be contested versus 23 for the Democrats. According to the Cook Political Report, there are seven Democratic seats currently rated as a toss-up, one likely to turn Republican, and two more seats that lean Democratic but in states where Republicans are judged to be very competitive. By comparison, there are only two Senate seats currently held by Republicans that are rated a toss-up. The Republicans will need to pick up only four seats to gain a majority in the Senate.

In the House of Representatives, the results will likely be closer. The Republicans currently have 30 seats that are classified by Cook as a toss-up or leaning Republican, while Democrats have 23 seats in those two categories. In order to gain a statistical majority of 218, the Democrats would need to pick up 26 seats. The bettors on Intrade (an online market that allows participants to trade futures contracts on various political outcomes) currently assign a 30% probability to that outcome. Of course, all this is merely informed conjecture—few anticipated the sharp gains enjoyed by the Republicans in 2010, for example. All we want to point out is that Democrats appear to have an uphill battle in the Congressional contests.

Of course, even a unified Congress can have difficulty getting laws passed that a sitting president opposes. Thus, the outcome of the presidential race will also be crucial, but it is also the hardest to call at this stage. Besides, just as the Republicans in the Senate can stifle Democratic initiatives and presidential appointments with the threat of a filibuster in the current Congress, the Democrats will be able to play the same game if they lose control of the Senate and the presidency. A clear voter mandate would help, but a newfound willingness among politicians to compromise in order to get things done would be even more valuable.

As we have previously noted, the problems facing the U.S. can be solved, given the political will. The solution roadmap we favor is that of President Obama's Simpson-Bowles Commission, which presented its findings at the end of 2010. It detailed $4 trillion of proposed deficit reduction measures through 2020. The proposals, which included broadening the tax base while reducing tax rates, capping discretionary spending, shifting defense spending to reflect new priorities, and raising the retirement age to reflect longer life expectancies, are common sense reforms that would give everyone confidence that U.S. fiscal policy is moving in the right direction. The challenge is that every major political constituency will need to give something up to get it done.

Global investors appear willing to let the U.S. engage in this year-long debate. Despite last summer's credit-ratings downgrade, U.S. Treasury bonds remain the preferred safe haven for investors. The value of the U.S. dollar strengthened almost 8% on a trade-weighted basis since mid-year, rising sharply against emerging and developed countries alike. Meanwhile, the U.S. equity market has outperformed most markets in the past 12 months by 10 to 20 percentage points. Winston Churchill said that, "Democracy is the worst form of government, except for those other forms that have been tried from time to time." He could have said the same thing about investing in the U.S. in 2011.

Emerging Markets: Shifting into a Slower Lane

At the beginning of 2011, the outlook for emerging economies was relatively bright. GDP growth rates were far superior to those of the advanced countries, and capital inflows into emerging-market debt and equity were exceptionally strong—too strong in some cases. We thought that inflation would accelerate, which would elicit a tightening of monetary policy in many of these countries. At the time, we maintained a mostly positive longer-term investment view, although we did point out that the strength in equity valuations fully reflected the asset class's strong fundamentals. As a result, we believed that a neutral stance toward emerging-market investments was appropriate.

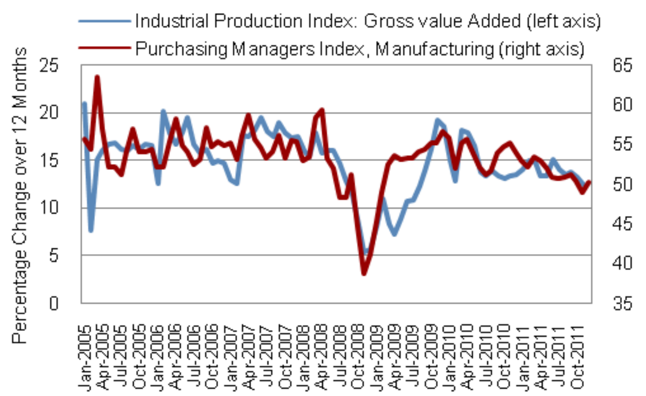
In 2011, these economies continued to grow well in excess of the advanced world, although absolute growth fell somewhat short of expectations in Asia and Latin America. While returns on emerging-market debt were solid in 2011 (up 7.35% in dollar terms as measured by the JPMorgan EMBI-Global Diversified benchmark), equity markets skidded a substantial 18% in U.S. dollar terms according to the MSCI Emerging Markets Stock Index. Not surprisingly, valuations have become rather attractive again following the decline. Despite that, judging by investors' tepid reactions, deterioration in economic outlooks seems to be trumping improvements in valuation.

In recent months, the worsening debt crisis in the eurozone has weighed especially heavily on Eastern European stock markets. Poland and Hungary, for example, logged 40% to 50% share-price declines in just the last six months. Elsewhere in the world, India has lost significant ground as its economic growth rate has slowed while inflation continues to accelerate (the rise in consumer prices recently exceeded 8.5% on a year-over-year basis). The economic turmoil associated with the Arab Spring and Libya's civil war hurt Middle East markets through much of the year, while the recent protests in Russia have hit stock prices in that country.

China, too, recorded a painful share-price decline last year of 18.2% (in U.S.-dollar terms) despite its exceptional growth. Indeed, the increasing bearishness of emerging-market investors appears to pivot around the outlook for that country. Although China's economy continues to grow strongly, there are developing signs of economic weakness. The pace of growth in exports, for example, has decelerated sharply as advanced economies stall, particularly in Europe. In addition, there are signs of a cool-down in previously bubbly private-property markets. This has caused consternation because investors aren't sure how badly the financial system in China would be affected by a serious retrenchment in the private-property markets. We note that the growth rate of the money supply in China has eased considerably. Over the past 12 months, growth in M1 (which generally consists of currency in circulation, demand deposits, and certain types of checking accounts) has been cut in half to an 8.5% rate of advance. At its peak in 2009, the M1 money supply grew 38% over a 12-month span.

The opacity of China's financial system and the questionable veracity of its official economic statistics are facts of life. If the country's leaders say that real GDP will grow 8% in 2012, it probably will, according to the official statistics. Especially as the country heads into its leadership change next October, we are skeptical that much bad news will be reflected in official economic data. For example, even though the country's purchasing-manager index for manufacturing has faded below a reading of 50%, actual industrial output has grown at a relatively steady rate of 13% or better over the past three years (see Exhibit 11).

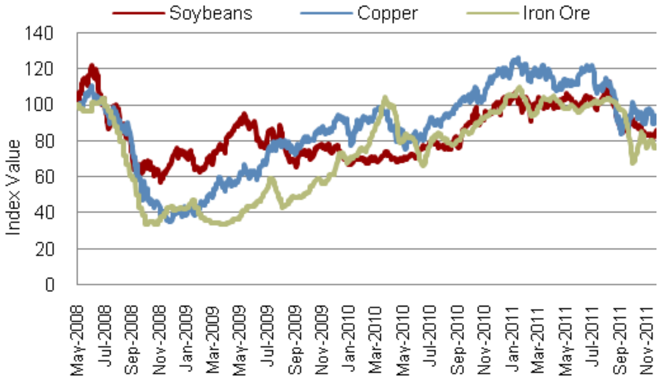
Exhibit 11: China—PMI versus Industrial Production



Sources: National Bureau of Statistics (China), SEI
A Purchasing Managers Index reading over (under) 50 indicates expansion (contraction) in manufacturing activity.

The weakness evident in many commodity prices may be a tip-off that China is experiencing a more challenging economic period than the official data suggest. Since China is the world's biggest consumer of many agricultural and industrial commodities, price trends should be a good (though not perfect) real-time indicator of the country's economic health. In Exhibit 12 on the following page, we highlight the negative trends in soybeans, iron ore and copper prices.

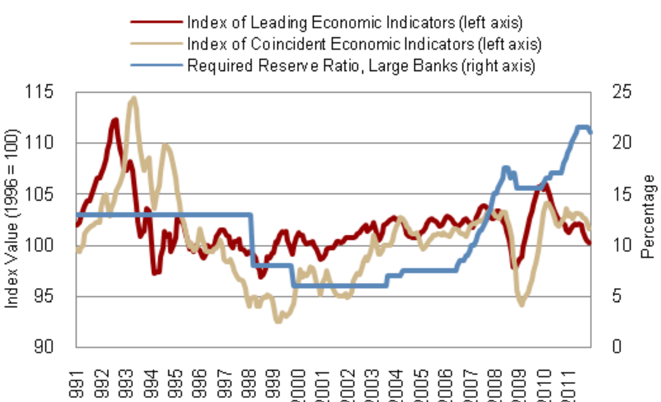
Exhibit 12: Will Commodities Keep Breaking Down?



Sources: London Metal Exchange, Metal Bulletin, U.S. Department of Agriculture, SEI
Daily index values rebased to 100 as of 5/30/2008.

On a positive note, the sharp decline in food prices over the past year has helped improve China's inflation picture. Consumer inflation on a year-over-year basis eased to a 4.2% rate, versus readings above 6% as recently as August and September. This has permitted the People's Bank of China (PBOC, the country's central bank) to take the first step in a new easing cycle. The Required Reserve Ratio (RRR) was reduced in December by one-half percentage point, the first such decline since December 2008. The PBOC has been aggressive in raising the RRR in recent years in its efforts to combat property speculation and inflation trends. The Chinese central bank sought to rein in credit growth even as the country's Index of Leading Economic Indicators (LEI) fell from boom-like to more neutral levels. We think China's LEI will continue to ease, providing a rationale for the PBOC to make additional cuts in the RRR well into 2012, as shown in Exhibit 13.

Exhibit 13: China—Ease is in the Air



Sources: National Bureau of Statistics, People's Bank of China, SEI

Positioning

We presently hold three key tactical views of capital markets for portfolios over which we exercise investment discretion:

1. *We are neutral on stocks versus bonds.* Following the double-digit gain in equities in October, we reduced our allocation to equities and increased our allocation to bonds, bringing both asset classes back into line with their strategic weights. Within equities, we favor a tilt toward U.S. Large-Cap stocks. U.S. economic activity has rebounded, although the overall growth outlook remains moderate at best. Business spending, however, has been robust, consistent with the ongoing strength in corporate profits. Household spending has also shown surprising strength, despite tepid growth in employment and incomes. Equity valuations remain attractive. Third-quarter reported earnings easily beat expectations (although those expectations had been previously revised downward). While corporate earnings growth is decelerating, a high single-digit return from stocks appears likely in 2012.

2. *We favor an overweight to U.S. versus international equities.* The debt crisis in Europe continues to metastasize, resulting in a slowing of growth in the core economies of Europe and near or outright recession in the debt-burdened periphery countries of Italy, Spain, Portugal, Ireland and Greece. Although the recent changes in political leadership in Italy, Greece and Spain are helpful, they have not yet been enough to stem the crisis. The economic and financial problems in Europe also could harm the growth prospects of emerging-market exporters.

3. *We favor an overweight to high-yield fixed-income versus investment-grade fixed-income.* Bond markets have exhibited surprising resilience in the face of the downgrade of U.S. Treasury debt by S&P, the threat of a downgrade in the sovereign debt of AAA countries in Europe, and the expansionary policies pursued by most developed-country central banks. U.S. Treasurys continue to be viewed as a safe-haven play by investors whenever market turmoil intensifies. Relative-value opportunities are more attractive in the high-yield space, although the ride has become quite bumpy in recent months. The option-adjusted spread of high-yield debt over Treasurys remains very attractive at around 725 basis points.

Watch Out for Those Black Swans

To quote Yogi Berra, “You can observe a lot by just watching.” We would add that, to be a successful investor, you not only need to observe the markets and the political environment, but you also need to observe your fellow investors. Much of this report has been focused on Europe because (1) the biggest financial and economic problems are emanating from there; (2) investors are demanding an immediate response by policymakers, in contrast to the longer rope being given to U.S. politicians; and (3) the economic and financial importance of Europe to the rest of the world is immense. However, Europe’s problems are well-known and are on the front page of the newspapers every day. Whatever happens over the next year may have some surprising wrinkles, but they probably will not come as a shock—not even a Greek default. It’s what happens on page 16 of the newspaper, not page one, that is likely to have a larger future impact on market prices (especially when those items suddenly and unexpectedly become front-page news).

This does not mean that a worst-case outcome in Europe is fully reflected in current market prices. On the contrary, the situation there is binary—things could improve dramatically or become far worse. If Greece opts out of the eurozone, there will be a painful period of uncertainty as investors work through all the implications and costs of debt default and banking system distress. In our view, though, European equities already have priced in a mild to moderate recession.

As the year 2012 gets underway, geopolitical developments could exert an important but hard-to-predict impact on financial markets. The Middle East remains an area of great ferment, for example. The radically changing power structures in Egypt and Libya, intensifying pressure on the ruling regime in Syria, the decline of U.S. influence in Iraq, and most importantly, the rising international tension over Iran’s nuclear program are factors that ultimately could result in another Middle East war and a spike in oil prices. About 4,000 miles (6,400 km) to the east-southeast of Tehran, the death of Kim Jong Il of North Korea creates what could be a highly destabilizing situation that could result in the country’s economic collapse. South Korea, China, the U.S., Russia and Japan all have a vital interest in what happens to that nuclear-armed state should it fail (or become more aggressive). Investors would likely flee for safe havens once again if the more dire scenarios come to fruition.

These are just a few examples of scenarios that have the potential to roil markets—in the parlance of former U.S. Defense Secretary Donald Rumsfeld, they are among the “known unknowns.” While investors must continue to pay attention to the “known knowns” of Europe’s debt crisis, American politics and slowing Chinese growth, they should also be attentive to the emerging and as-yet-unidentified risks and challenges of our times.