

The Most Peculiar Month of the Year?

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- With central banks implementing aggressive monetary easing in a world mostly characterised by slow economic growth and mild inflation pressures, we believe any pullback in the price of riskier assets should be limited.
- The U.S. and China continue to move slowly forward as the U.K. cut interest rates in preparation for the fallout from Brexit.
- Weak macro trends and central bank support have kept rates at levels never before seen in the history of finance.
- We expect value stocks to come back into favour versus their stability-oriented peers.

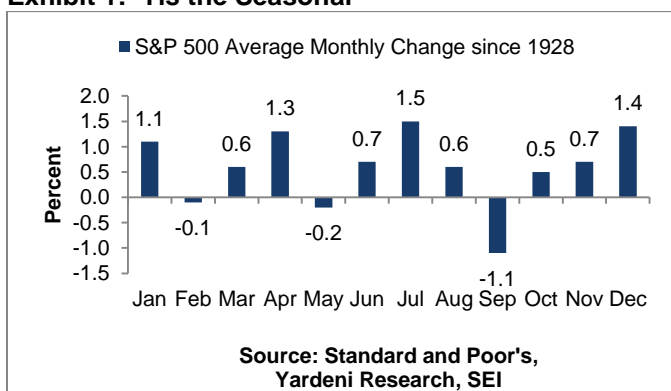
“October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.”

— Mark Twain, *Pudd'nhead Wilson's Calendar for 1894*

Twain's witty words of market wisdom never grow old. His choice to highlight October was prescient. October 1929, which recorded a 20% price drop in the S&P 500 Index in simulations, still lay 35 years in the future. Ninety-three years later on October 19, 1987, known as Black Monday, we saw a 20% one-day price plunge in the S&P 500 Index — and a drop of 22% for the month as a whole. And then, more than a century after Twain's observation, the S&P 500 Index plummeted 17% in October 2008.

But the cleverness of Twain's quote is in its emphasis on October as one of the “peculiarly dangerous” investing months — among 12 *equally* “peculiarly dangerous” months. As it turns out, despite a few notable October declines, it is not the worst month to be in stocks. According to data supplied by Yardeni Research Inc., September is by far the worst performer, on average, followed by May and February (Exhibit 1). October turns out to be a middling sort of month.

Exhibit 1: 'Tis the Season!

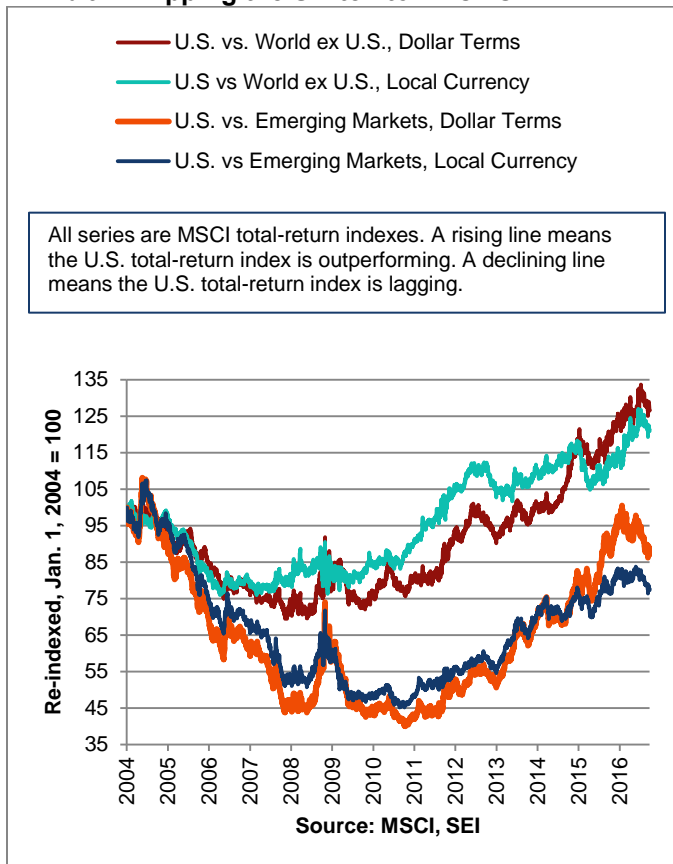


This past September managed to live up to its bad historical profile, although not horribly so. U.S. equities, as measured by the MSCI USA Total-Return Index, fell slightly in the month, but gained 3.3% over the quarter. By contrast, the MSCI All-Country World ex USA Total Return Index posted positive returns in September in both U.S. dollar and local-currency terms. For the quarter as a whole, international equities performed exceptionally well, advancing about 7% as post-Brexit-vote fears faded in Europe, and emerging markets continued their massive rally from the lows of January and February. From a longer-term perspective, however, the U.S. has been the clear leader over the past five years (Exhibit 2).

There are many things over which investors can lose sleep. These include continuing global economic uncertainties; the possible economic and financial stresses stemming from an eventual Brexit; the growing disenchantment with free trade and globalisation; the apparent ineffectiveness of monetary policy and the lack of credible government economic policy leadership generally; the growing pressures on corporate profit margins; severe sovereign- and corporate-debt burdens; and intense political uncertainty in many countries, including the U.S. But our over-arching investment stance remains unchanged. As long as central banks pursue aggressively easy policies in a world mostly characterised by slow economic growth (not recession) and mild inflation pressures, the pullback in the price of riskier assets should be limited. Our inclination is to favour equities and higher-yielding debt securities at the expense of developed-economy sovereign bonds that have extremely low or negative yields. Within equities,

we prefer value and aggressive-growth characteristics over stability and interest-rate sensitivity. In bonds, we favour securitised credit, bank loans and other credit-related trades.

Exhibit 2: Flipping the Switch to “Risk On”

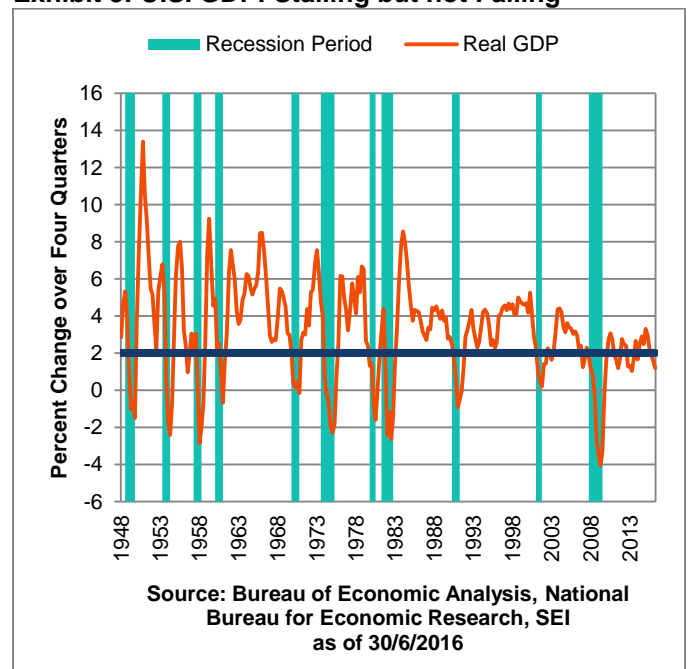


Recession Fears Ebb and Flow; the Economic Tide still Rises

In general (and especially as it pertains to the U.S.), we have viewed all the sharp equity-market corrections since 2010 as buy-on-the-dip opportunities for investors who have ready access to cash or who have been sitting on the side lines waiting for an opportunity to re-enter the market. One reason for maintaining this point of view is our belief that the U.S. economy is on fairly solid ground. It’s true that growth in overall business activity continues to disappoint, with inflation-adjusted gross domestic product (GDP) advancing an anaemic 1.3% over the four quarters ended June. Much of this weakness stemmed from the harsh recession in the oil patch and the generally sluggish trend in world economic activity and trade. Both fixed investment and the inventory change component have been negative over this period. The only real bright spot has been the household sector, buoyed by the expansion in employment and incomes.

On almost every occasion since 1950, when the four-quarter change in U.S. real GDP slid below 2%, economic growth would keep sagging and eventually fall into recession (Exhibit 3). The one exception prior to the current cycle was 1956. Since 2011, however, GDP growth has meandered around its 2% “stall speed” line persistently, dipping below that line three times. We believe that another reacceleration back above 2% growth is coming. Household finances are in good shape as a result of decent employment trends and the bull market in stocks, bonds and home values. There is little reason to expect a serious slowing in consumer spending.

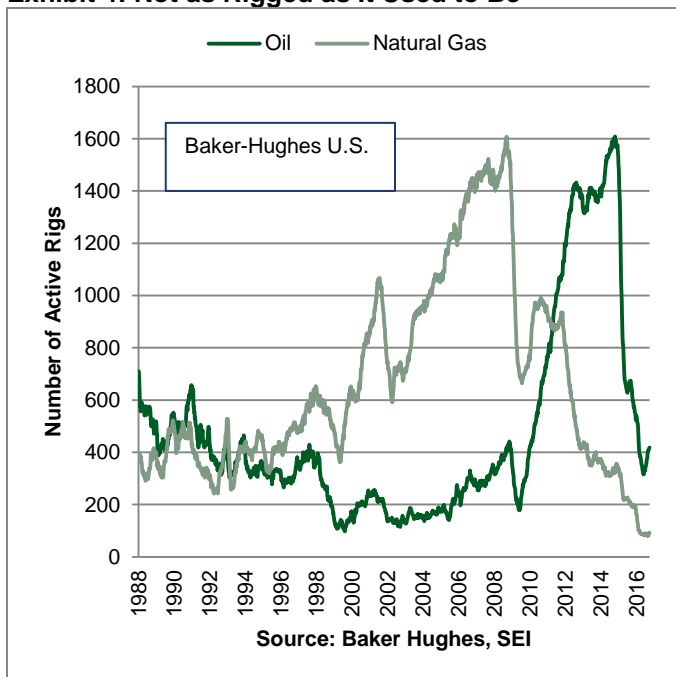
Exhibit 3: U.S. GDP: Stalling but not Falling



We also expect the inventory change component — the most volatile part of GDP — to turn around and contribute positively to growth, following five consecutive quarters of decline. The change in business inventories has slowed dramatically, from a high rate of accumulation to an outright contraction, as of the second quarter of this year. As inventories are rebuilt in the quarters ahead, we will look for a reacceleration in overall GDP into the 2.5%-to-3.0% range.

Our main concern for the U.S. is weakness in business investment on equipment and structures. The decline in expenditures on pipelines and oil-related equipment has been especially severe since the fracking boom turned into a bust. Although much has been made of the turnaround in the rig count in recent months, Exhibit 4 places that recovery in perspective — the total number of oil rigs operating in the U.S. is still 75% off its October 2014 peak.

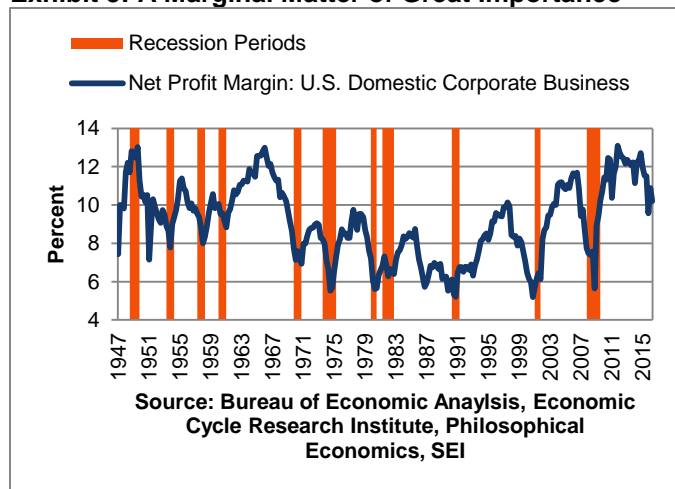
Exhibit 4: Not as Rigged as It Used to Be



U.S. oil production has fallen more than 5% in the past year. This downturn in the U.S. has pushed total world oil output into contraction despite continued production gains by the Organization of the Petroleum Exporting Countries (OPEC) and Russia. Although some observers have expressed optimism that global demand and supply is converging, the inventory glut has not been removed. Crude oil prices are unlikely to advance very far above current levels for some time, perhaps years. As the fracking process becomes more efficient and the cost of production declines, it will be tough for crude oil to exceed the \$55-to-\$60 range without far greater production discipline than is currently displayed by OPEC.

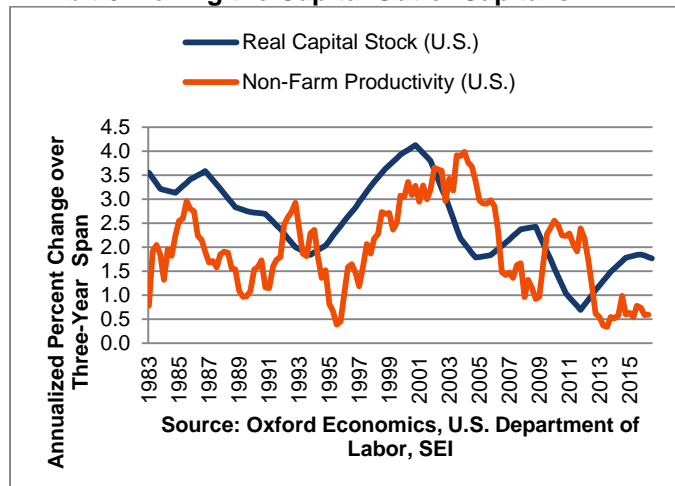
On the positive side, other types of capital spending not as sensitive to the commodities cycle are doing better. Intellectual property (software, artistic/literary as well as research and development) continues to expand at a mid-single-digit pace. But there's no denying that the business sector is being stressed. Exhibit 5 tracks the net profit margin of U.S. domestic corporate business, as derived from the GDP accounts. Although the cycle peak occurred back in 2011, the margin has stayed elevated until rather recently. The good news is that margins are still high relative to the historical record. The bad news is that the trend is downward, and margin deterioration usually precedes economic recessions.

Exhibit 5: A Marginal Matter of Great Importance



The poor investment trend has depressed the growth of the country's capital stock (plant and equipment), with negative implications for productivity. The extremely slow pace of productivity growth in recent years is becoming a major concern for economists. When output per hour fails to grow, living standards stagnate and inflation pressures can increase. It's possible that the slowdown in productivity has been exaggerated by measurement issues; it's hard to gauge the productivity impact of technology innovators like Uber, Facebook or Amazon. Nonetheless, we would caution against complacency. The long-run connection between U.S. growth in the capital stock and productivity can be clearly seen in Exhibit 6.

Exhibit 6: Taking the Capital Out of Capitalism

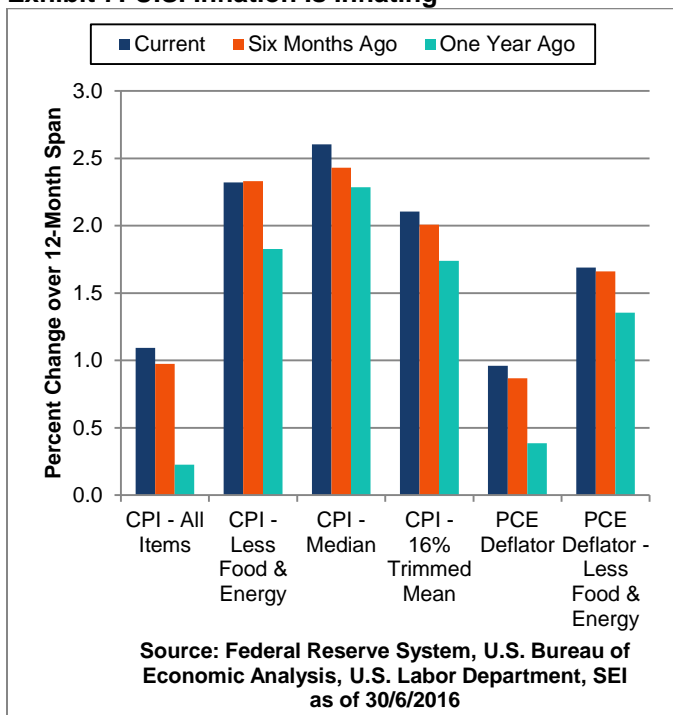


Slowing labour productivity growth and an acceleration in labour compensation growth is a bad combination, leading to higher unit labour costs. In recent years, increases in unit labour costs have been running above 2%. Since companies have been unable to raise prices sufficiently, the downward pressure on profit margins

appears chronic. As this pressure intensifies, we expect companies will become more aggressive in their attempts to push through price increases.

Higher inflation, we believe, is almost certainly in our future. Exhibit 7 shows a few different measures of U.S. inflation. All of them have accelerated, at least modestly, versus their year-ago readings. Among the more widely followed inflation yardsticks, the core consumer price index (excluding food and energy) is up 2.3% versus the year-ago level, while the total CPI index is up 1.1% through August. Although considerably lower than the core inflation reading, the tumble in energy prices is still working its way through the numbers. After next February, the energy component should begin to push the headline CPI higher. We expect total CPI inflation to be running above the core rate by next spring.

Exhibit 7: U.S. Inflation Is Inflating



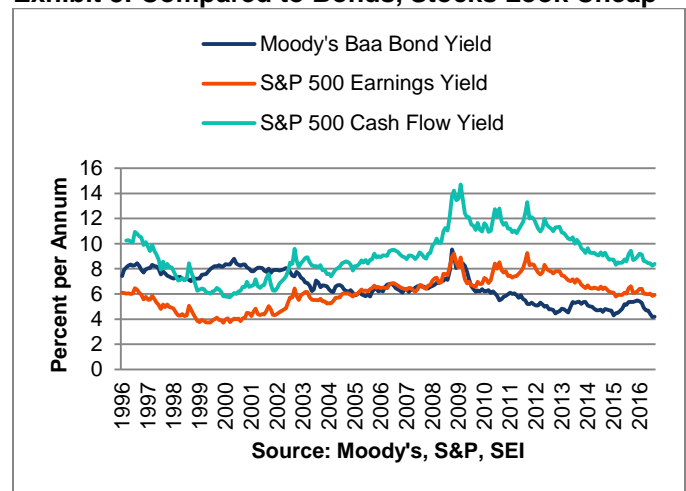
The Federal Reserve's (Fed) official inflation measure, upon which policy is based, is the personal consumption expenditures (PCE) deflator. It remains better behaved than the CPI, but is beginning to accelerate. Through August, the PCE deflator has gained 1.0% over the past 12 months for the total index, and 1.7% for the core measure. The PCE price index will also likely gather pace as weak energy prices drop out of the calculations. This uptick in inflation, combined with the tightening labour market and slow-but-steady pace of economic growth, seems to have tipped the balance in favour of a hike in the federal funds rate, probably in December. Since the policymakers at the Fed have been vacillating over pushing the federal funds rate by a mere quarter percentage point all year long, this shift probably should

be considered big news. But even with another interest-rate move, no matter how you measure it, the level of short-term rates should stay well below the current rate of inflation.

At their latest meeting, Fed policymakers finally conceded that interest-rate normalisation will take years to accomplish. Their projections call for two increases in the federal funds rate during 2017, followed by three more in 2018 and another three in 2019, to a level of 2.6%. Even the long-run equilibrium rate is now judged to be below 3%. This is unprecedented in modern times. It leaves little ability to cut rates aggressively in the event of a recession.

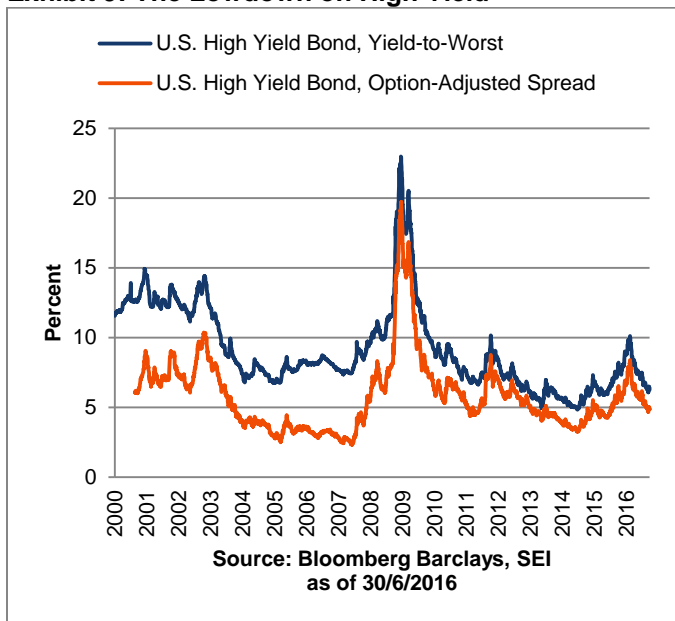
Investors remain sceptical that the central bank will even achieve its stated objective of pushing its policy rate to the upside. As a result, risk assets should continue to be well supported. Although equity valuations remain elevated, they still appear reasonable relative to those of high-quality bonds. Exhibit 8 tracks the earnings yield (that is, the inverse of the price-to-earnings ratio) and the cash-flow yield on the S&P 500 Index. It compares those two measures against the yield on the Baa corporate bond. Although spreads have narrowed, they remain comfortably above the bond yield.

Exhibit 8: Compared to Bonds, Stocks Look Cheap



In the corporate high-yield market, the outlook remains positive. Maturities through 2017 appear manageable, despite a rising trend in default rates. Yield-to-worst and options-adjusted spreads (as measured by Bloomberg Barclays) have narrowed sharply since mid-February, as Exhibit 9 shows, reflecting the rebound in energy and other commodity-oriented companies' bonds.

Exhibit 9: The Lowdown on High Yield

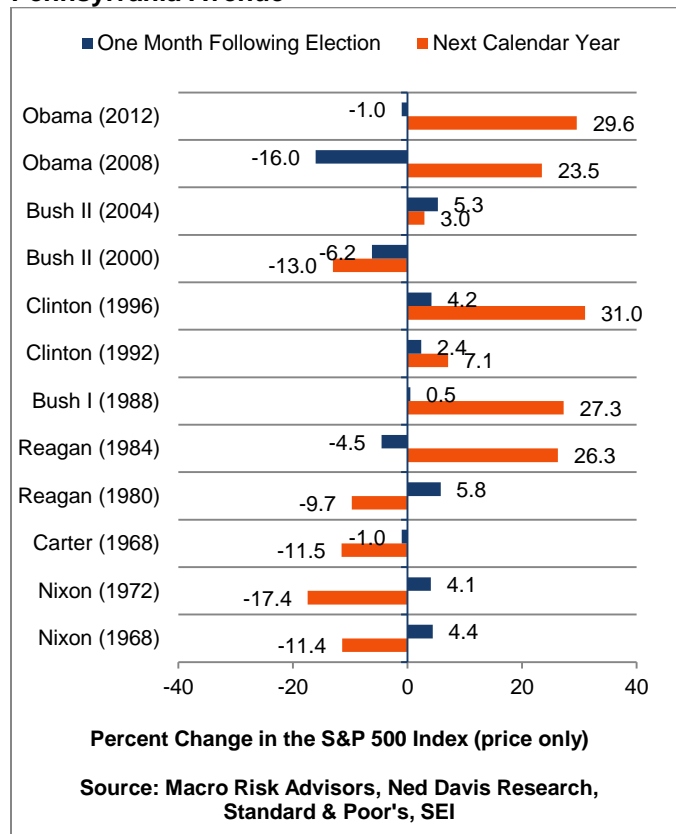


When Making Investment Selections, It's Best to Ignore the U.S. Elections

As much as we would like to do so, we can't deny the elephant and the donkey in the room. The U.S. presidential election will have an impact on the economy and financial markets in the months and years ahead. The choice is a stark one, in terms of policy and style. Yet, we firmly believe that it would be a mistake to base even a short-term investment strategy that necessitates picking a winner in November; predicting the policies proposed by the new president; figuring out how those proposals will be modified by Congress on their way to becoming actual laws; and forecasting the impact those laws would have on the economy and financial markets. One only needs to look at the reaction to the Brexit vote over the past three months to see the futility of trying to make such predictions.

Exhibit 10 on the following page documents the S&P 500's one-month and one-year returns following each of the last 12 presidential elections, starting with Richard Nixon's victory over Hubert Humphrey in 1968. Looking at this chart, the only thing that can be said with any confidence is that markets have a tendency to be more volatile both immediately following the presidential election and over the following year. What cannot be said with any conviction is the direction or ultimate magnitude of the change.

Exhibit 10: A Random Walk Down Pennsylvania Avenue



We won't get into the weeds about specific policies. But there are some points worth consideration. Both candidates seem set on providing a traditional Keynesian fiscal policy boost via government intervention, with an emphasis on infrastructure. Donald Trump seems willing to pursue a far more aggressive fiscal tack, cutting taxes dramatically in Reagan-esque fashion. On the downside, trade protectionism may worsen under either candidate.

Regardless of the election's outcome, our bias will be to assume that the worst will not happen. There is a high degree of institutional inertia, which is partly deliberate (constitutional checks and balances) and partly happenstance (increasing polarisation of opinion in the country tends to favour a draw). Unlike President Barack Obama in his first two years in office, the next president will be constrained when it comes to fiscal matters.

China: The Mandarins Count on Ease

Getting the economic trends in both the U.S. and China right is important because the former is the single largest country in terms of world GDP (26%), while the latter (15% of world GDP) has been by far the biggest contributor to incremental growth. At the start of this year, China observers were fairly glum about the nation's economic prospects. The country's financial

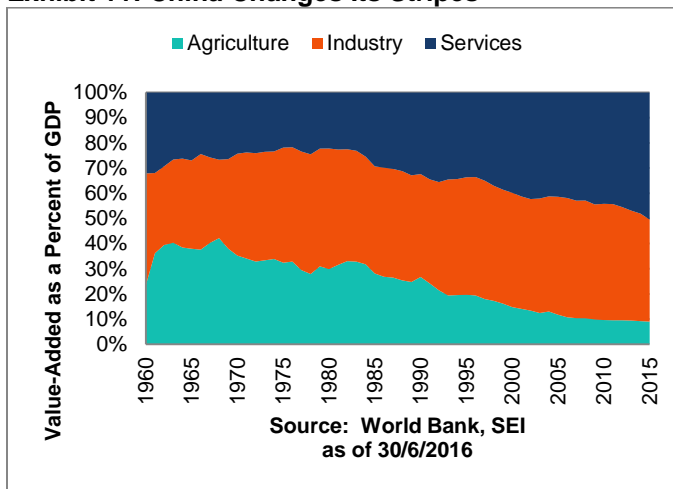
markets took a dive in August 2015 (taking international markets with them) after the government announced its intention to manage the renminbi versus a currency basket instead of the U.S. dollar. By the start of this year, however, bearishness regarding China had spiked to such a high pitch that we proffered some reasons for optimism in our Economic Outlook report.

We noted, for example, that the economy's deceleration phase appeared to be drawing to a close. Home sales and prices were picking up. Retail sales were relatively buoyant. Most important, we saw government policy shifting gears toward additional monetary and fiscal stimulus. While structural economic reform was not being abandoned, we thought it would be placed on the back-burner in the short-run in the interests of shoring up GDP growth and easing pressures on the country's over-indebted banking system.

Fast-forward nine months, and investors now appear less fearful. The MSCI China Total-Return Index is up 34% from its February low in U.S. dollar terms, and is almost 9% above its year-end 2015 level. The renminbi has depreciated steadily in the year to date, falling 7% against a basket of currencies and less than 3% against the greenback — a depreciation modest enough that it kept the issue from being the leading topic for U.S. politicians in a presidential election year. (Yes, Trump has vowed to declare China a currency manipulator if he becomes president, but the debate over China still seems more of a sideshow next to other issues.) While the depreciation of the renminbi has not reinvigorated exports, it appears to have stopped its two-year decline.

Domestic economic growth in China has been relatively stable this year, with retail sales growing around 10% on a year-over-year basis and industrial output running at a 6% rate. Importantly, the country continues to evolve into a services-oriented economy, with that sector now accounting for more than half of GDP (Exhibit 11).

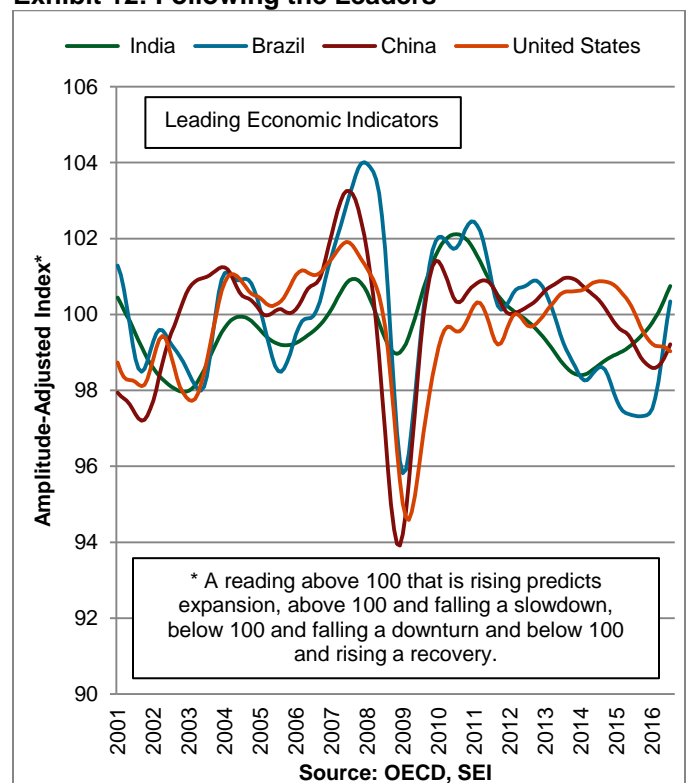
Exhibit 11: China Changes Its Stripes



Housing activity also has picked up. The question now becomes whether government economic policy flips back toward structural reform and economic rationalisation and away from stimulus, given that business activity looks to be in a less fragile state than a year ago.

We have not detected any major change yet. We think China's economy will continue to reaccelerate in the near term. The OECD's leading economic indicators (LEI) index for China provides corroboration for this view. Although the country's growth rate remains below trend, the index shows an improving trajectory following two and a half years of slowdown. The leading indicators statistic for China has several components, including chemical fertiliser production, manufactured crude steel output, overseas order levels, building construction, motor vehicle production and share turnover on the Shanghai Stock Exchange. In Exhibit 12, we compare China's LEI against those of India, Brazil and the U.S.

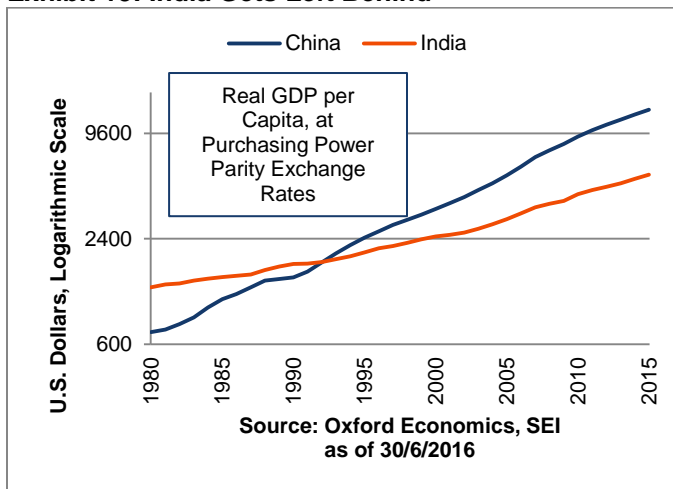
Exhibit 12: Following the Leaders



Notice that China's LEI is just starting to hook higher. India's leading indicators have been on the mend since the start of 2014; according to this metric, the Indian economy is now growing above trend. The recovery in Brazil is even more dramatic; although this mainly reflects the big rebound in its equity market. GDP and industrial output remain exceedingly depressed, yet there has been a modest lift off the low in the former.

Before the global financial crisis, the U.S. and China were the primary growth engines of the world. Those engines are sputtering when compared to their pre-crisis performance. We think it's possible that India eventually will become a third major engine of global growth. In the past year, its GDP growth was greater than China's. While its population is nearly as large, India is growing faster and is much younger. As India institutes economic, financial and legal reforms, it has the potential to grow rapidly for a long time. Exhibit 13 shows how China GDP per capita has far outpaced that of India. We see little reason why the latter country cannot enjoy a similar multiyear growth spurt, and begin to close that gap in the coming decades. After years of bickering, India's parliament finally passed a uniform goods-and-services tax that is expected to take effect as early as April 1, 2017. This is a major accomplishment that could accelerate GDP growth by over one percentage point per annum, owing to the streamlining of the tax code and the breaking down of barriers to trade that have inhibited the free flow of goods and services from one part of the country to another.

Exhibit 13: India Gets Left Behind



In the near term, SEI sees a continuation of the rally in emerging-market stocks and bonds. Political developments in Brazil and Argentina have generated optimism that pro-business and pro-investor reforms will be instituted. Valuations in the area are still judged to be attractive despite this year's big market rally and currency appreciation. Brazil is still in recession, but there is light at the end of the tunnel as political uncertainties ratchet down. Although we do not expect a hard landing, concerns remain.

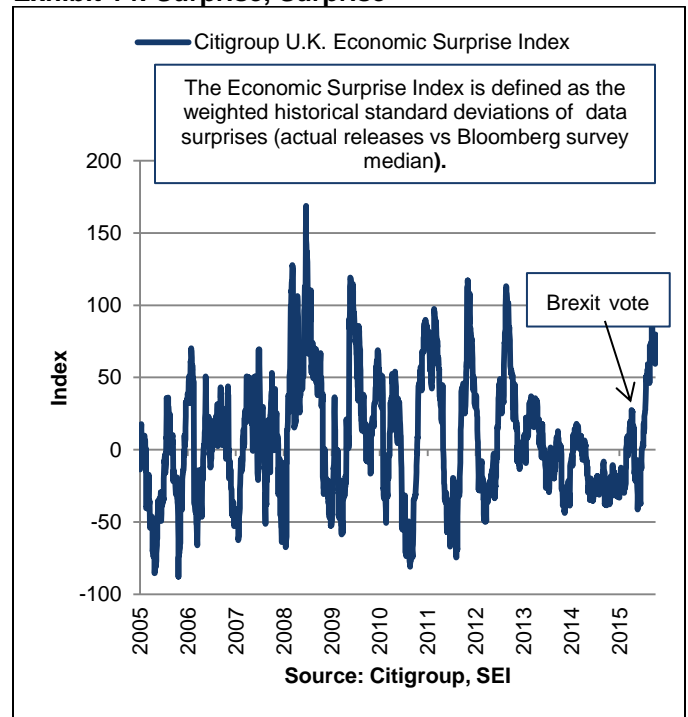
Europe Goes the Other Way

Compared with the breaking down of internal barriers to commerce in India, Europe seems to be going in the opposite direction. The Continent is perceived as a less attractive locale for large, multinational corporations,

thanks to Britain's vote to exit the European Union (EU), the European Commission's decision to force Ireland to reclaim almost €13 billion (plus interest) in back taxes from Apple Inc., and the aggressive enforcement of anti-trust law against U.S. companies. Even the trade agreement painstakingly negotiated by Canada is in jeopardy of being pulled, while there is scant hope for a successful conclusion to the Transatlantic Trade and Investment Partnership (TTIP) between the EU and the U.S.

With regard to the U.K., many observers have been surprised by the resiliency of its economy. Exhibit 14 displays the Citigroup Economic Surprise Index for the U.K. Even before the Brexit vote in late June, this statistic was starting to improve. But the magnitude of positive surprises since then has been rather surprising. Nevertheless, it is way too soon to sound the all-clear for the U.K. economy.

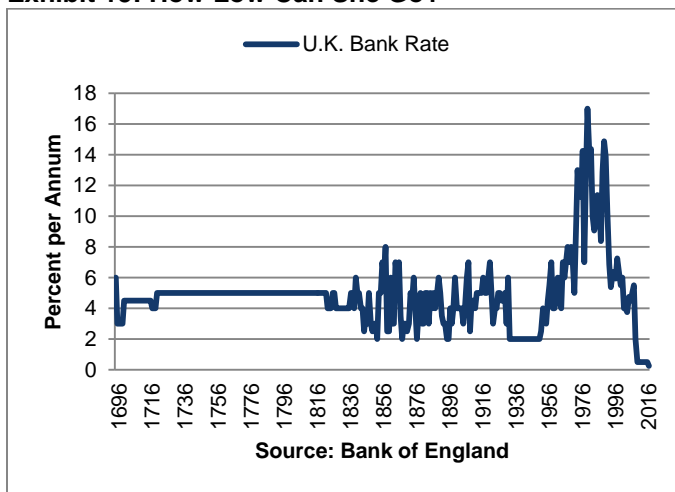
Exhibit 14: Surprise, Surprise



As we pointed out in the immediate aftermath of the Brexit vote, the timetable to exit the EU is still very much up in the air. The government must first invoke Article 50 of the Lisbon Treaty before serious negotiation gets underway. Newly elected Prime Minister Theresa May has announced that this will take place by the end of March. In the meantime, the U.K. still enjoys the full benefits of remaining in the EU — with a significant improvement in its competitive position, thanks to sterling's sharp depreciation.

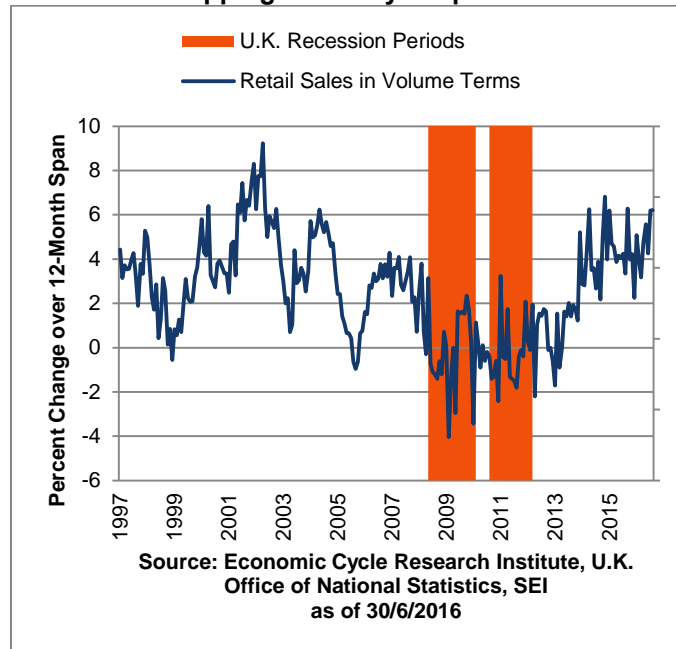
In addition, the Bank of England (BoE) has pre-emptively cut its base rate to the lowest level in the long, multi-century history of the central bank (Exhibit 15). The BoE also has restarted its quantitative-easing program and previously successful funding-for-lending scheme. On the fiscal policy side, new Chancellor of the Exchequer Philip Hammond jettisoned his predecessor's austerity plans and is expected to introduce a new budget in November (the "Autumn Statement") that abandons any notion of achieving a budgetary surplus by the end of the current parliament. In all, U.K. economic policy has shifted dramatically toward ease well before the negative effects of Brexit can be felt.

Exhibit 15: How Low Can She Go?



At this point, the U.K. economy even appears to be growing at a slightly better clip than that of the U.S. Although some sentiment indicators dipped in reaction to the shock of the vote to leave the EU, other data highlight the fact that economic strength is waxing and not waning. Retail sales volumes through August have gained a remarkable 6.2% over the past year, just about matching some of its best performances over the past 15 years (Exhibit 16). Part of this may be owing to a surge in tourism elicited by sterling's decline. Industrial production eased somewhat in July, but has been on a modestly improving path over the past four years. On the other hand, construction activity has stalled, declining over the 12 months ended June; this compares to previous growth rates in the 7%-to-8% range registered as recently as two-to-three years ago. High-end residences in London already are seeing a pullback in selling prices.

Exhibit 16: Shopping 'Till They Drop

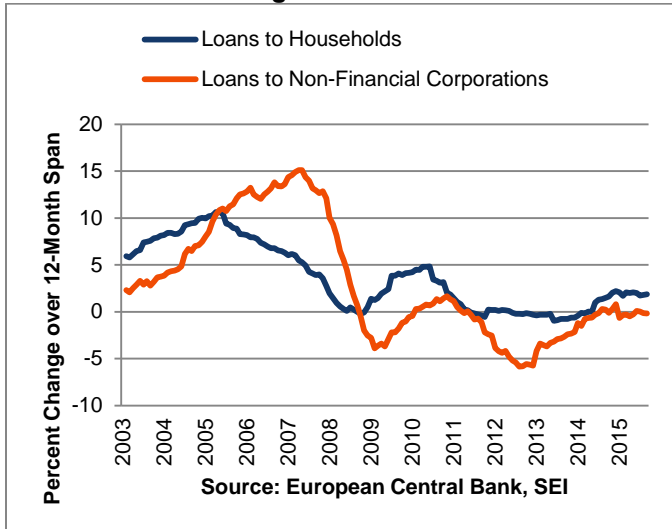


Despite the economy's near-term strength, we still harbour deep concerns over the impact of Brexit once the Article 50 trigger is pulled. We find the early trial balloons on the details of a future deal somewhat disheartening. U.K. negotiators hope to put tight constraints on the free flow of people and eliminate contributions to the EU budget, yet maintain so-called passporting rights that will keep business as usual for the London financiers and preferential tariffs for other exporters. While no one knows what a final agreement will look like, we suspect it will be nowhere near the position being pushed forward by various U.K. leaders. Given this uncertainty, we think investment is likely to slow in the months ahead. The labour market might also lose some resiliency.

The Eurozone Hangs On

At his September press conference, European Central Bank (ECB) President Mario Draghi proclaimed that the central bank's negative-interest-rate and quantitative-easing policies were working just fine. As proof, he cited the growth in household and business loans. Count us as sceptics. As Exhibit 17 shows, loans to businesses remain flat as a pancake, consistent with manufacturing output that has also flat lined during this period. Loans to consumers have risen, but year-on-year growth has been running at only 2% — less than half the gain registered in both 2010 and 2011.

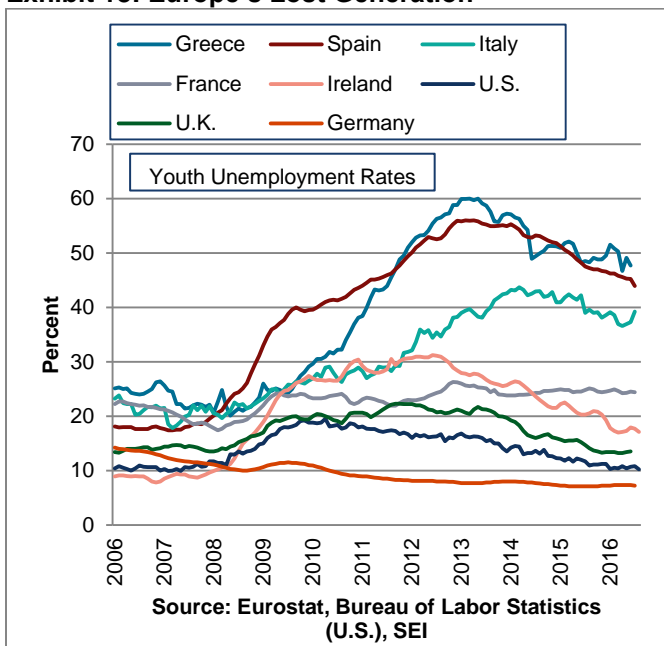
Exhibit 17: Mario Draghi's Proud Achievement?



Meanwhile, both exports and imports are in decline. Household spending is growing faster than other areas of the economy, as is the case in the U.S. and the U.K., but Europe's consumer rebound remains considerably less robust in comparison with these two countries.

Although the labour market has certainly improved over the past three years —with the eurozone unemployment rate falling to 10% from 12% — the country-by-country levels remain wildly disparate. This is especially so for the youth unemployment rate (which measures unemployment among those less than 25 years of age). Exhibit 18 clearly shows that the periphery countries of Greece, Italy and Spain continue to endure extraordinarily high rates of joblessness among younger people.

Exhibit 18: Europe's Lost Generation



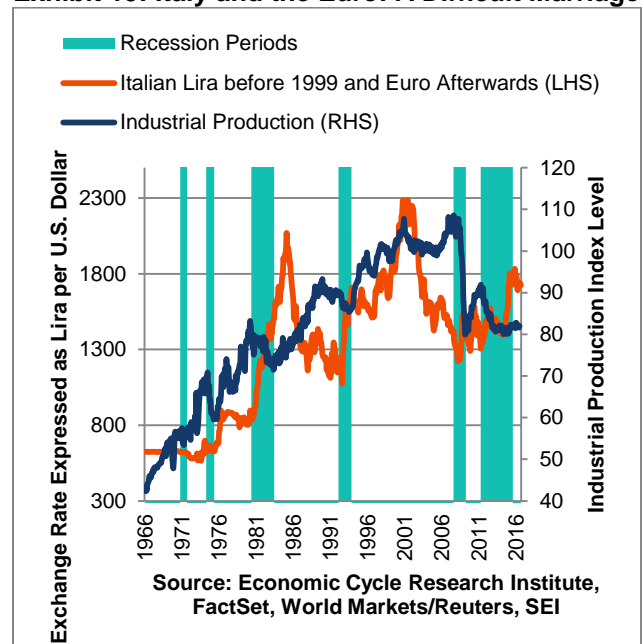
Italy has even seen an uptick in the youth unemployment rate in recent months. By comparison, Germany's youth unemployment has been amazingly low since the financial crisis. This is the result of an effective vocational apprenticeship program allied with the well-functioning and hyper-competitive German economy.

Youth unemployment is just another way of highlighting the yawning competitive gulf within the eurozone, in addition to its structural rigidities. It also helps explain ongoing German resistance ("We're doing fine — what's the problem?") to easing the austerity pressures on the periphery. We're concerned that it's just a matter of time before another crisis rears its ugly head and once again tests the cohesion of the eurozone.

It's possible that the Italian constitutional referendum, to be held December 4, could provoke such a crisis. If the vote goes against the government, Prime Minister Matteo Renzi may be forced to make good on his previous promise to hold elections. Unfortunately for him, polls show that the Italian electorate is in a cantankerous mood. But who could blame them? The past eight years have seen slow growth or outright recession, high unemployment and unremitting austerity.

The pain actually goes back far longer than the global financial crisis of 2008, at least for Italy's manufacturers. The euro became the country's formal accounting currency on January 1, 1999, replacing the lira. It was at that point that Italy gave up its monetary independence. Exhibit 19 highlights the relationship between Italy's Industrial Production Index and its currency (the lira prior to 1999 and the euro thereafter).

Exhibit 19: Italy and the Euro: A Difficult Marriage



Prior to 1999 and the creation of the monetary union, the lira was a chronically weak currency. Inflation was a major problem too. Periodic currency depreciation, however, was an important release valve for the economy, offsetting the decline in the country's manufacturing competitiveness that would have otherwise occurred as unit labour costs rose. Unfortunately for the Italians, entry into the monetary straitjacket of the euro also coincided with China's rise as an export powerhouse.

We have little doubt that an independent Italian central bank would have weakened the lira considerably during the 2008 financial crisis. This was the response following all other recessions in Italy since the mid-1970s. Instead, the euro more-or-less maintained its value against the U.S. dollar for the next six years. According to the Economic Cycle Research Institute, Italy was forced to suffer through recessionary conditions from May 2011 to July 2015 — a period of more than four years. Although the euro has weakened significantly against the U.S. dollar since June 2014, it has not been by nearly enough to help lower the country's high unit labour costs versus other major exporting countries.

If the Five-Star Movement, currently the most formidable Italian opposition party, were to win power, the impact would be far more earth-shaking than the Syriza party's January 2015 victory in Greece. Italy's population is three and a half times that of Greece, the size of its economy some seven times greater and the size of its external debt almost four times as large. Considering the difficulties inside the eurozone that followed hard on the heels of Syriza's victory in January 2015, one can only imagine how markets will react to the possibility of an Italian threat to leave the euro framework.

ECB President Draghi knows he has a potential problem on his hands. He continues to reassure investors that the central bank has the will, the tools and the ability to improve the eurozone's fortunes. Yet he also surprised ECB-watchers in September when he conceded that the central bank's governing council had not yet considered ways to expand its asset-purchase program. Divisions within the eurozone that have made bail-out efforts such a struggle since 2010 remain. If anything, they are likely to worsen as the periphery countries get increasingly pressed by their debt, and as their citizens grow more restive over an austerity that seems to have no end.

Japan Tries Something New

While much of Europe has been struggling against economic quicksand for the past eight years, Japan has been on unstable ground for more than a quarter century. Its level of GDP growth is just about back to where it was in 2008, yet its nominal GDP is not much

higher than it was in the early 1990s — an indication of how entrenched deflation has been in Japan over the years.

Despite fiscal stimulus packages, structural reforms and extremely aggressive monetary policy initiatives, the Japanese economy still lacks momentum. Industrial output has trended lower over the past three years, hurt by the slowdown in global trade, Europe and China's economic sluggishness and the recent sharp appreciation of the yen. Although the country's merchandise trade balance has turned positive, this is merely the result of imports falling faster than exports: imports are down by a third from their 2014 peak.

On the positive side, housing construction is running near a cyclical high. In the labour market, the number of unemployed has sunk from a peak of 3.5 million persons in 2009 to about two million as of August. The unemployment rate, which is structurally much lower than in other developed countries, dipped to 3.1%. Nominal wage increases remain stuck near zero, however. Inflation expectations have been nearly impossible to nudge to the upside — mostly because the absolute headline CPI level continues to decline. Total consumer prices fell 0.5% in the year ended August; excluding food and energy, the increase amounted to just 0.2%.

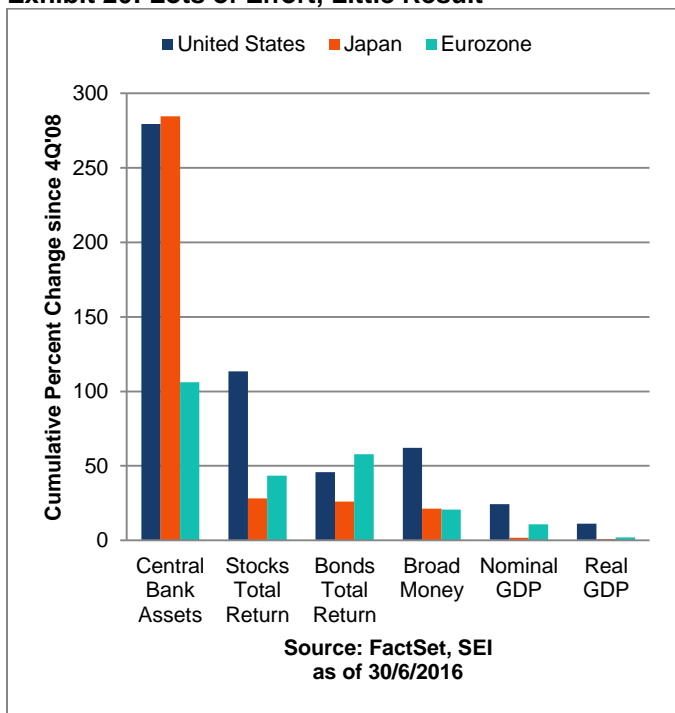
As is the case elsewhere, there is a growing concern that monetary policy in Japan is losing its effectiveness. Negative interest rates and a flattish yield curve have been punishing banks, insurance companies and savers of all stripes. Although the Bank of Japan (BOJ) has indicated that further declines in short-term rates are on the table, it has now changed its focus. It will conduct its bond buying with an eye toward keeping the 10-year Japanese government bond (JGB) pegged at zero for an indefinite period. The goal is to encourage an upward sloping curve, while keeping the term structure of interest rates at low levels. The BOJ also wants to raise inflation above its previous target of 2%, and keep it there for a considerable time. This strategy implies that inflation-adjusted yields on the 10-year bond will become increasingly negative as long as the central bank pegs the nominal yield at zero. Yields further out the curve presumably would rise as investors begin to price in a higher long-term inflation rate, helping to steepen the curve (at least that's the theory).

It's also widely hoped that credit growth will accelerate as the basic business of borrowing short and lending long becomes more profitable for financial intermediaries. Whether this will work in practice is a good question. The latest monetary policy initiatives do not include any step-up in the rate of asset purchases by the BOJ. It certainly doesn't address the difficulties that

arose as result of the yen's 20% appreciation against the U.S. dollar in the year to date.

Exhibit 20 is a reminder that quantitative easing has not exactly been a stunning success anywhere in the world, especially when it comes to boosting economic growth. Since the fourth quarter of 2008, the BOJ and the U.S. Fed have nearly tripled their assets. The ECB has only doubled its assets, underscoring the central bank's late start in this reflation game. All this liquidity, though, has done little to boost either nominal or inflation-adjusted GDP. It's true that stocks and bonds have responded positively to this monetary manipulation to some degree (more in the U.S., less elsewhere). But keep in mind that higher asset prices is just an intermediate goal of quantitative easing. What asset reflation has not done is boost economic growth to acceptable levels or lift the inflation rate in Japan and Europe toward their target levels.

Exhibit 20: Lots of Effort, Little Result



While negative interest rates and a strong yen are market negatives, our Asia-based managers are heartened by the improvements in corporate governance and the use of capital. Additionally, the latest fiscal-policy initiative is a significant one, with new spending amounting to ¥7.5 trillion. In the current fiscal year, stimulus is expected to reach 4.5% of GDP.

Being Paid to Take Risk

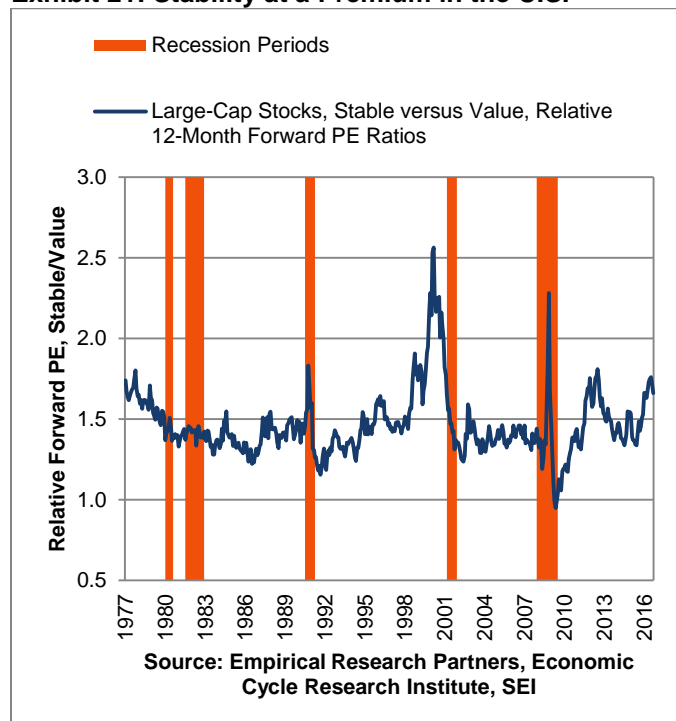
The impact of the global financial crisis continues to reverberate. Efforts to prevent a repeat of the international banking system's near-collapse — amid

increased regulation, higher capital requirements and the exit of previously lucrative lines of business by the major multinational financial companies — have had a role in subduing the credit-creation cycle and tempering the rebound out of recession. Other factors, of course, have come into play, including demographics, labour-market rigidities, the eurozone debt crisis and the long period typically needed to repair household and corporate balance sheets after a massive debt bubble turns to bust.

We have seen central banks around the world take the lead in combatting deflation and weak growth in the absence of a fiscal policy response, especially in the U.S. and Europe. But the various tools at the disposal of those central banks are blunt, and the unintended consequences profound. Among these consequences is the search for yield and bond proxies by investors as bond yields have been pushed toward zero and into negative territory.

Michael Goldstein, founder of Empirical Partners, has done a great deal of work studying this phenomenon. His findings show that stable stocks are trading at close to a 70% premium to value stocks, in terms of forward price-to-earnings ratios (Exhibit 21).

Exhibit 21: Stability at a Premium in the U.S.

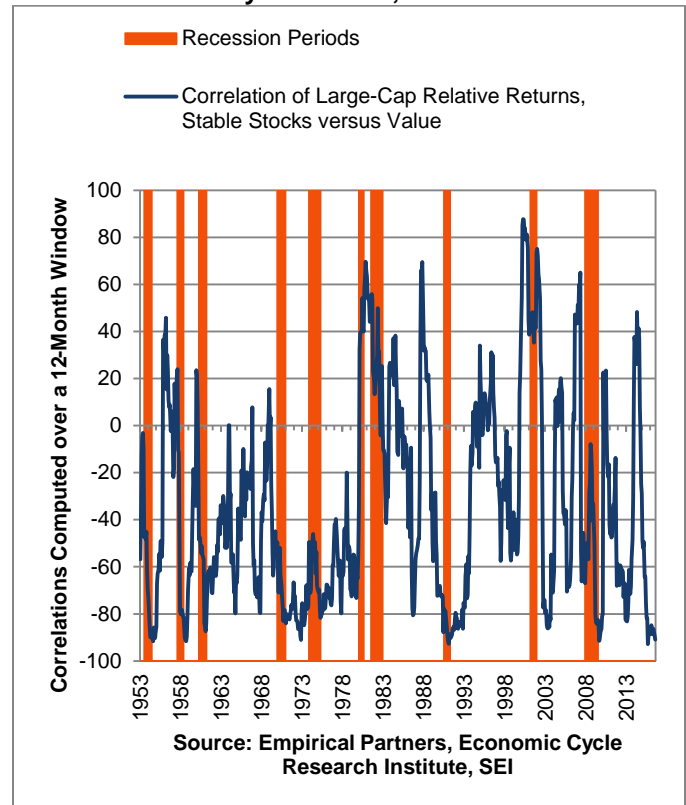


To be sure, the relative valuations in favour of stable issues have been higher — the 1998-to-1999 technology bubble most notable. SEI is betting that a similar overshoot in relative price-to-earnings will not be repeated. Up until now, investors have been willing to ignore the valuation differential, holding the view that

weak macro trends will stay in place and central-bank policymakers will continue down the same road — keeping rates at levels never before seen in the history of finance.

While stable issues are pricey relative to value stocks, we find the extremely high negative correlation between the two even more remarkable. As of September, that correlation is a negative 90%. Exhibit 22 illustrates that this could be as extreme as it gets. Until this negative correlation reverses, investors need to make a choice. Either they assume that bond proxies and stability-oriented issues continue to run to the upside despite their high premium to value, or value stocks come back into favour.

Exhibit 22: Stability and Value, Like Water and Oil



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ⁱ Information prior to 4 March 1957 is back-tested, based on the methodology that was in effect on that date. Back-tested performance, which is hypothetical and not actual performance, is subject to inherent limitations because it reflects application of an Index methodology and selection of index constituents in hindsight. No theoretical approach can take into account all of the factors in the markets in general and the impact of decisions that might have been made during the actual operation of an index. Actual returns may differ from, and be lower than, back-tested returns.