

## First Quarter 2012: Economic Outlook

# The Rally at Six Months: Riding the Wave, But Watching Out for Shocks

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The Global Portfolio Strategies Group recently released its first-quarter 2012 economic outlook. A summary of its conclusions is provided below:

- Equity markets around the world have recorded a price gain of close to 20% over the past six months, and the S&P 500 has advanced more than 28% from its closing low on October 3.
- Instead of taking a contrarian stand as we did six months ago, we are more inclined to go with the flow, maintaining a pro-cyclical investment stance until valuations become more worrisome, or the economic trends start to point toward another period of uncertainty and volatility.
- The current bull market pales against the multi-year gains seen in the 1920s or during the latter half of the 20th century. The bottom line: This is no baby bull, but there is no reason to think that it will die of old age anytime soon.
- The deleveraging of households and the banking system has been more dramatic in the U.S. than in other advanced countries. The credit-creation machine is starting to operate once again.
- We believe current economic policies, both in the U.S. and abroad, are setting the groundwork for a higher inflation rate in the years ahead.
- We expect the pressure on the U.S. Federal Reserve to tighten policy will become significant as the unemployment rate falls below 7%. This is a reason to be cautious about Treasury bonds and other safe-haven assets.
- In Europe, Greece still has a tremendous challenge ahead of itself. In addition, political developments in France—and investor reaction to those developments—should be closely watched as a leading indicator of what may occur elsewhere over the next few years.
- As might be expected in a strong global bull market environment, emerging-market equities have participated in the advance, although the outperformance versus large-cap U.S. stocks has been relatively modest in both the year to date and since the October bottom.
- It can be fairly argued that the risk-on trade is in need of a rest. A 30% rise from the October lows in U.S. equities may have been justified, but it has resulted in excessive near-term optimism.
- We are neutral on stocks versus bonds, removing our tactical (short-term) overweight to equities across our portfolios and moving back to our strategic (long-term) positions. Although we believe equities are likely to experience a period of pullback and consolidation in the months ahead, we do not expect a severe reversal like the one seen last year.
- We favor an overweight to U.S. versus international equities. Although Europe has made some progress in dealing with its periphery debt crisis, it will continue to face periods of stress. Emerging markets will likely continue to grow at a faster clip than the U.S., but China, India and Brazil all have issues that lessen their near-term attractiveness.
- We favor an overweight to high-yield fixed income versus investment-grade fixed income. The financial health of high-yield debt issuers suggests that this asset class should continue to outperform Treasuries and investment-grade bonds.

A full-length paper is available if you wish to learn more about this timely topic.

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