Economic Outlook

Fourth Quarter 2014

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Staying Optimistic—Despite all the Good News

By: James R. Solloway, CFA, Managing Director and Senior Portfolio Manager

- We remain optimistic regarding global equity markets.
- Developed international markets should provide more consistently positive performance in 2015, given the tailwind of lower energy prices, more accommodative monetary policies and some easing of the fiscal constraints that have hurt the eurozone in particular.
- With valuations in the U.S. higher than in some other countries, we are shifting to a more balanced view of relative performance. The U.S. may still do well, but some other markets might do better.

While it's often been said that bull markets climb a wall of worry, what happens when that wall crumbles? Amidst slow but mostly positive economic growth, an historic decline in oil prices, near-zero interest rates and the ardent pursuit of unconventional monetary policies by the world's most important central banks, it is tempting to be clever and assume that the bull market is in jeopardy: If everyone is bullish who's left to buy? The volatility in equities and other riskier assets since September would seem to confirm this view, but that logic might be a bit too clever. In our view, it is probably a mistake to over-think things. Rather, as we look ahead to the New Year, we believe there are a few simple points to keep in mind:

- The collapse in oil prices is a net positive for oil consuming countries and regions, both developed (the U.S., Europe, Japan) and emerging (China, India, Asia-Pacific including South Korea).
- Lower energy prices will encourage central banks to keep ultra-easy monetary policies in place for longer and encourage additional governmental measures aimed at economic stimulation (i.e. more aggressive quantitative easing, less fiscal restraint) in countries and regions where inflation is already well below target (eurozone, Japan, South Korea, India).
- Equity valuations may be elevated in the U.S. compared to other countries, but relatively strong and steady profits growth justifies the higher earnings multiple applied to the U.S. stock market. Meanwhile, equity markets that have badly lagged the U.S. in recent years could start to play catch-up, assuming economic growth starts to gain traction.
- While it's still a scary world out there, the oil price slide hurts some of the more nefarious actors on the world stage—Russia, Iran, Venezuela, the Islamic State (ISIS), etc. Anything that constrains or moderates their aggressive behavior is good for the investment outlook.

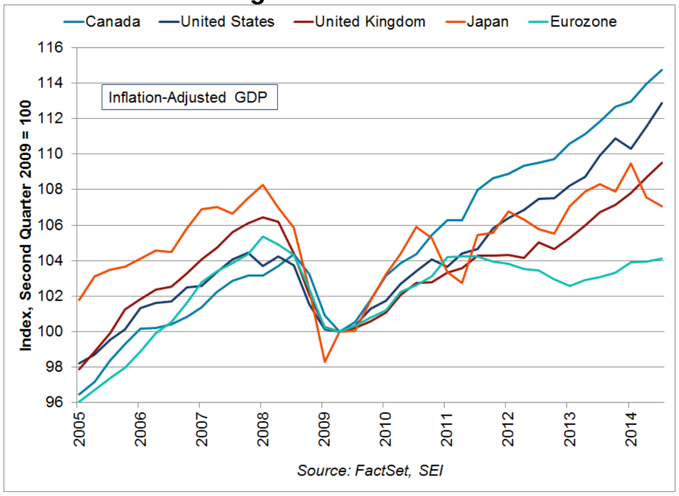
Our base-case scenario remains an essentially constructive one, with high single- or low double-digit equity gains in many developed markets, a wide variety of outcomes in emerging stock markets, modest upward pressure in global bond yields as economic growth prospects improve and challenging commodity markets within a strong-dollar environment.

Of course, every year has its share of surprises and unanticipated market reactions. In addition to reviewing our outlook, we will consider some potential bumps in the road.

The U.S. Economy Still Leads the Way

It's no secret that the U.S. has been one of the better-performing economies since the end of the global recession in 2009. Through the third quarter of 2014, it logged a cumulative increase in inflation-adjusted gross domestic product (GDP) of 12.9% from the second quarter 2009 trough (Exhibit 1 on the following page), with the third-quarter annualized gain registering a strong 5% rate. Nonetheless, even this performance has been widely viewed as a disappointment in the aftermath of the deepest recession of the post-World War II period. In fact, the U.S. recovery of the past five years is among the weakest of the ten prior recovery periods since 1949. Economy-watchers (ourselves included) have been consistently too optimistic about the prospects for growth. Employment and income trends have stayed surprisingly sub-par (at least, until recently), despite record-low interest rates, robust earnings and a booming stock market.

Exhibit 1: Not Enough Growth



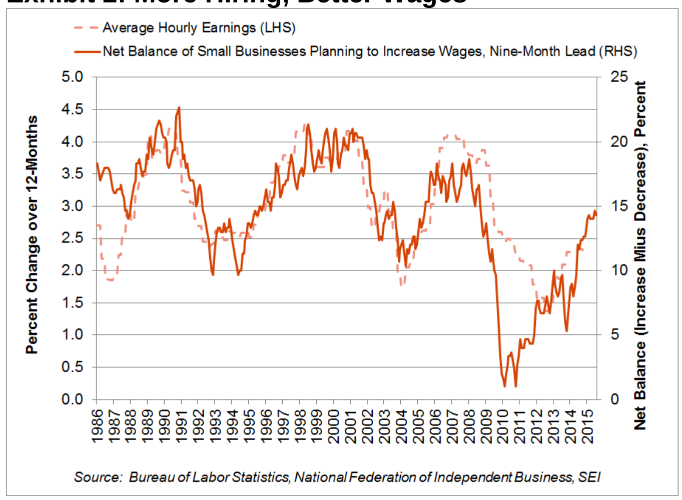
Much tougher mortgage qualification requirements have stymied the typical V-shaped recovery in the housing markets. Business spending (outside the energy sector) has been slow to rebound owing to slack capacity utilization and an unusually strong commitment to capital discipline that has funneled cash flow into dividends, stock buybacks and mergers and acquisitions rather than physical expansion. Finally, direct government expenditures at all levels—federal, state and local—has been held in check, subtracting about a percentage point from overall GDP growth in recent years.

From the investor's perspective, however, this disappointing growth outcome has not seriously impeded the bull market run in equities (outside of periodic downdrafts, most notably the near-20% correction in 2011 and the mid-2013 "taper tantrum" that hit high-yield debt and emerging markets particularly hard). Profit margins in the U.S. continued to move further into record territory in 2014 and estimated earnings over the next 12 months rose 6%, despite some weakness in the fourth quarter as analysts factored the decline in oil prices into their models. An expansion in the multiple from 15.4 times forward earnings at the end of last year to 16.2 times currently, combined with a 2% dividend yield, pushed the S&P 500 to a 13.7% total return over the past year. This performance beat most investors' expectations, since it followed a 32.4% advance in 2013.

It is possible this unusual dynamic of prolonged subpar growth, weak labor income gains and rising profit margins is finally starting to change. The steady improvement in the U.S. labor market in recent months suggests that a turn in labor costs to the upside is on the way.

Most measures of employment (e.g. sharp declines in the unemployment rate, accelerating payroll growth, cyclical highs in job openings and new hires) appear to signal a more robust expansion phase. Small businesses, the chief generators of jobs growth, have recorded a major rise in optimism over the past year to levels not seen since 2006. Exhibit 2 highlights one of the sub-components of the monthly survey conducted by the National Federation of Independent Business (NFIB): the net balance of small businesses planning to increase wages. The attraction of this series is its normally close correlation to the percentage change in average hourly earnings, leading earnings growth by roughly nine-months. On a year-over-year basis, average hourly earnings growth bottomed out in late 2012 and has been stuck around 2.2% for the past two years. If the relationship with the NFIB survey holds, however, we could see a quickening in average hourly earnings growth to almost 3% in 2015.

Exhibit 2: More Hiring, Better Wages



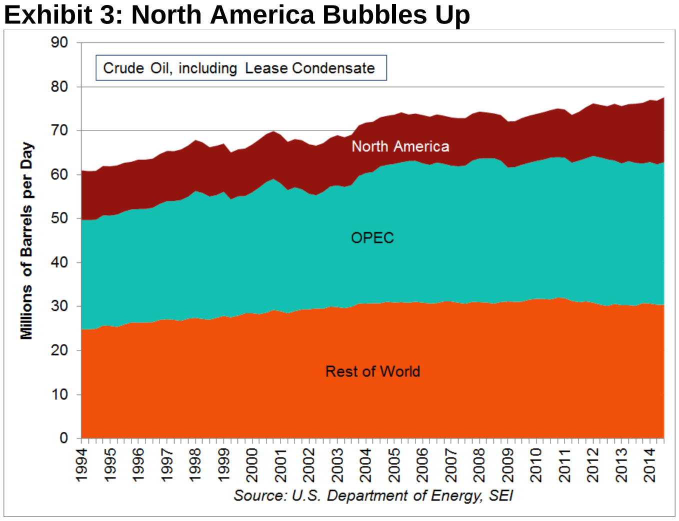
Rising labor costs can be expected to have a negative impact on profit margins. However, the offset should be a more vibrant household sector, as increases in employment, earnings and hours worked contribute to a meaningful improvement in aggregate incomes and spending. Under this scenario, corporate earnings can still rise at a mid- to high single-digit pace; however, instead of being driven by profit margins, the key driver would be top-line growth.

The big decline in gasoline and other petroleum-related prices provides a nice tailwind to households and businesses. North American energy producers, on the other hand, face a shake-out of severe proportions. This is an eventuality that is still in the process of being discounted by investors. The drilling boom in places like Texas and North Dakota is in danger of turning into a bust. The outcome depends on how far oil prices decline and how long they stay depressed.

Crude prices peaked in the middle of 2014, well before OPEC's fateful decision not to cut production at its November meeting. The decline in the price of Brent oil, the international benchmark, now amounts to about 50% from its 2014 high.

Worldwide growth in oil demand is appreciably more subdued than during the 2003-2007 expansion due to slower demand growth in China and other emerging markets, tepid economic growth in the U.S., outright stagnation in Europe and on-going conservation efforts (including the subsidization of alternative energy sources). But the big story in the past few years is the step-up in North American production as a result of hydraulic fracturing ("fracking") in the U.S. and tar sands extraction in Canada. Exhibit 3 shows the upward drift in total world oil production. According to the U.S. Department of Energy, production from the Organization of the Petroleum Exporting Countries (OPEC) peaked in the second quarter of 2012 at a rate of 33.5 million barrels per day (MMBD). It has since fallen 3% through the third quarter of 2014. Non-OPEC, non-North American output, meanwhile, peaked in 2010 and has declined about 5%. In contrast, North America (essentially the U.S, Canada and Mexico) has recorded gains in production amounting to 4.6 MMBD, a 45% jump, to 14.8 million MMBD since the cyclical trough in 2008. The U.S. accounts for 87% of the North American crude output increase, with total crude production in the U.S. up almost 85% over the past six years to an 8.7 million MMBD rate as of the third quarter of 2014.

Exhibit 3: North America Bubbles Up

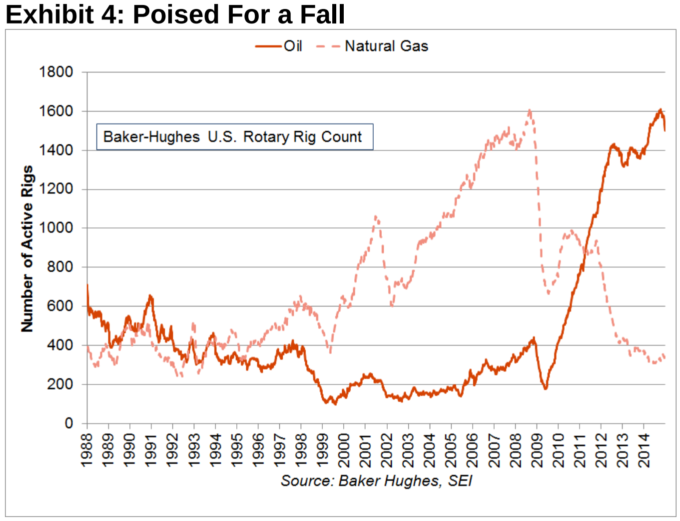


Saudi Arabia's decision not to act in its traditional role as the swing producer of the world's oil market reflects a combination of economic and geopolitical realities. Its oil reserves dwarf those of North America or any other country. It is in the Saudis' best interests to slow the pace of development of fracking in the U.S. (not to mention alternatives energy sources like solar and wind power), in order to maintain market share in the long term. Geopolitically, the Saudis also want to pressure the Iranian economy to such a severe extent in the near term that the Iranian regime will agree to rein in its nuclear ambitions and submit to robust international oversight. Both goals imply a prolonged period of deeply depressed oil prices likely to last beyond the next OPEC meeting (scheduled for June 2015).

It will take months for supply and demand to recalibrate. Demand, of course, is fairly inelastic—big price declines do not lead to large consumption increases. Developed countries will continue to impose ever more restrictive efficiency mandates on automobiles, the Japanese government will seek to reduce its dependence on oil by restarting the nuclear plants that were shut down after the March 2011 earthquake and tsunami, Europe will continue to seek big reductions in fossil-fuel usage and China will, over time, try to follow the developed-market model of improving energy efficiency and seeking economic growth that is less energy-dependent and polluting.

The production response should be more rapid, but even here, we should be thinking in terms of months and years, not days or weeks. The U.S. oil rig count (shown in Exhibit 4) should fall dramatically in 2015, perhaps tracing a path similar to the decline since 2009 in gas rigs. Note, however, that even in an environment highlighted by a significant drop in the number of rigs, U.S. natural gas production has continued to increase and is up some 40% since 2005. As fracking technology advances and production costs decline, it is possible that U.S. oil production will remain surprisingly resilient even in the face of dramatically lower price points.

Exhibit 4: Poised For a Fall

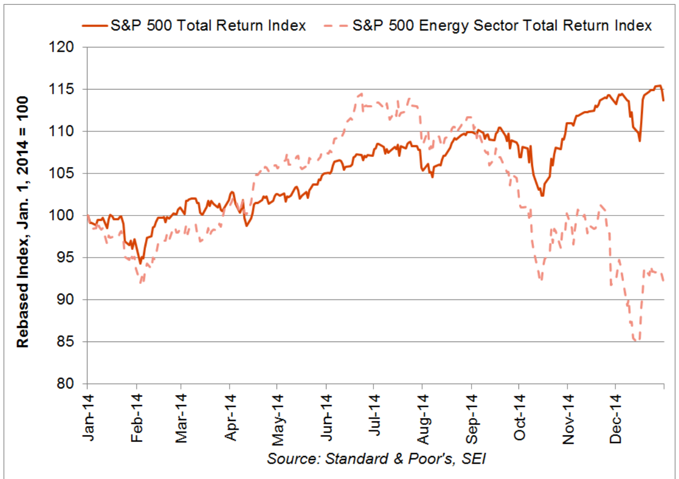


We will not pretend to know where the near-term bottom in oil prices might be. During the financial crisis, for example, West Texas Intermediate imploded from a high of $145 per barrel to a low of almost $30. We think a return to that deeply depressed level is improbable; it certainly seems to be unsustainably low in a global economy exhibiting signs of improving growth.

We would conjecture that a price range of $50-to-$70 a barrel might be the new normal for an extended period. Nuclear concessions by Iran, the willingness of the rest of OPEC to show more production discipline, a global step-up in economic growth and, of course, Saudi leadership as the largest swing producer are the necessary conditions for oil-price stabilization and improvement in 2015. Since the Saudis are not rushing to cut their production, we look for oil to trade at the lower end of that range for the next several months.

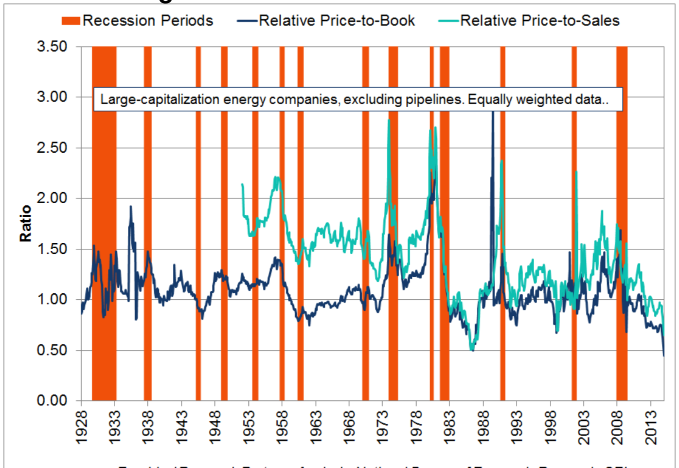
Given this pessimistic outlook for oil, it is no surprise that energy companies have seen their stocks prices crater. The S&P 500 Energy Index was down more than 21 percentage points against the S&P 500 in the past year, with almost one-half of that relative underperformance coming since the OPEC decision in late November. Exhibit 5 highlights the decline. Although it takes a certain kind of risk-taker to catch a falling knife, value investors should be sniffing around this battered sector (judging by the big uptick in the S&P Energy sector in mid-December value investors are showing interest). Michael Goldstein, head of Empirical Research Partners, recently published a report showing how cheap the S&P 500 Energy sector has become relative to the overall market. Exhibit 6 showcases two of those metrics. The sector's price-to-book ratio relative to the S&P 500 (with data back to 1928) and the relative price-to-sales ratio (measured from 1952) are at or near record lows. Of course, the denominator in both ratios will decline to a significant but unknown extent as a result of the oil-price collapse. Still, it can't be denied that investors have already downgraded their views of the sector quite dramatically. This sentiment paves the way for a contrarian opportunity.

Exhibit 5: Oil Stocks Fall Hard



Source: Standard & Poor's, SEI

Exhibit 6: Big Oil Gets Drilled



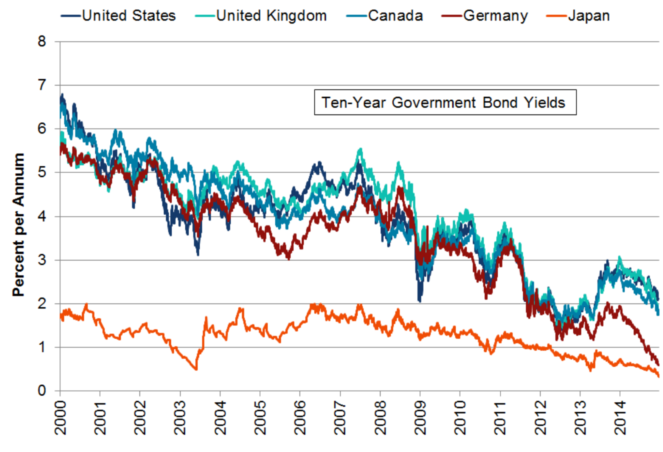
Empirical Research Partners Analysis, National Bureau of Economic Research, SEI

Deflated Inflation Expectations

The drama in oil prices has resulted in another twist of the knife in the inflation rate, both in the U.S. and globally. One proxy of inflation expectations in the U.S., the spread between nominal Treasury yields and those on Treasury Inflation-Protected, has declined to its lowest level in more than five years, with five- and ten-year breakeven rates at 1.3% and 1.7%, respectively. We haven't seen actual inflation rates this low over a five-to-ten year span since the early-to-mid 1960s.

Over the next six months, we would expect 10-year Treasurys to remain range-bound between 2% and 2.5%. The yield curve should continue to exhibit a flattening bias as investors anticipate the beginnings of a slow and extended rate-increase cycle beginning in mid-2015. U.S. bonds at the long end of the yield curve, however, should be supported not just by the benign longer-term inflation outlook, but also by the very low yields that prevail abroad. One of the big surprises of 2014 was the continued downward march in long-term interest rates across developed countries. At the start of 2014, U.S. 10-year Treasury bonds were trading near 3%. We thought they would drift higher throughout the year, but that expectation was upended by the weather-induced contraction in U.S. GDP in the first quarter, worldwide economic stagnation and the inexorable slouch toward deflation in Europe. As Exhibit 7 on the following page shows, German bunds have retreated toward Japanese-like yield levels, taking the rest of the developed world with them.

Exhibit 7: Bonds Test the Lower Bound



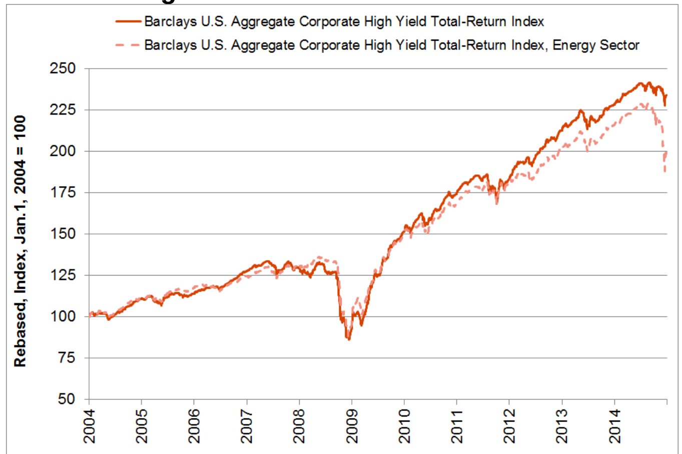
Source: Tullett Prebon Information, SEI

U.S., U.K. and Canadian bond yields remain closely correlated with each other, reflecting similar inflation and growth prospects. Germany, along with other core European countries, however, has seen its yields diverge toward the downside. At year-end, U.S. 10-year Treasurys yielded 164 basis points above their German bund counterparts. One doesn't normally see U.S. Treasury-German bund spreads this wide; on the last two occasions this happened (in 2006-07 and in 1999) the U.S. and world economies were in the final stages of their cyclical expansions. We see no sign of a cyclical top this time around, so perhaps this spread can continue to widen.

Finally, we are keeping an eye on developments in the high-yield market. In recent years, we have held a positive view on the asset class owing to relatively attractive yields versus investment-grade bonds and their appeal as a less volatile alternative to equities in the midst of an improving economy. The high-yield market has weakened in recent months, however. The Barclays Corporate High Yield Index rose a modest 2.5% in total-return terms during 2014 as energy issues plunged a dramatic 14% since early September, as shown in Exhibit 8. If oil prices stabilize, one can again begin to make a bullish argument for the asset class. Credit selection, however, has become critical. Our managers are looking for names that have recently underperformed in sympathy with energy.

There is widespread agreement that Fed policy will slowly move away from the extraordinary measures that have been in place since the global financial crisis six years ago. Quantitative easing (QE) ended in October, and policymakers at the Fed continue to project the start of a Fed funds rate interest rate up-cycle in the middle of 2015. Markets, reacting to the oil price drop, imply the first rate hike is more likely to take place in July or September. In any event, any move to normalize rates is expected to be done in an extremely cautious fashion. The Fed might stick to its forecast of an initial move in June, but there will be no urgency to push through a series of hikes until underlying inflationary pressures become more prominent.

Exhibit 8: High-Yield Hits a Low Point



Source: Barclays, SEI

Currencies in Debasement

Another important development in 2015 should be the widening divergence in the direction of monetary policies between the U.S. and other major central banks. The Fed is expected to tighten policy (cautiously) while the European Central Bank (ECB) and Bank of Japan (BOJ) will likely be easing. This theme was on our radar screen this time last year, thanks to the introduction of "Abenomics" in Japan and the forceful turn toward quantitative easing in that country. We argued at the time that the ECB would be compelled to follow the BOJ's lead down the road of unconventional monetary policy. But it took a further deterioration in economic activity and a worrisome decline in the region's inflation rate for the ECB to respond to the challenge. Even now, it is pursuing less dramatic variants of QE than other central banks, with the current focus on covered bond and asset-backed securities (ABS) purchases and lending to banks via the so-called Targeted Long-Term Refinancing Operations (TLTROs).

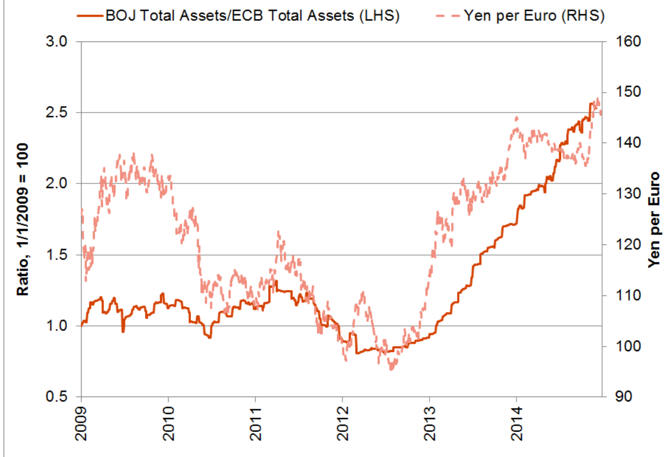
Since the Jackson Hole gathering of monetary policy officials in August, ECB President Mario Draghi has been stating with increasing stridency that the ECB's goal is to expand its balance sheet by 50%, or €1 trillion euro, back to the level that prevailed two years ago. He also has become more forceful in voicing his desire to push eurozone inflation back up toward 2%. This represents a dramatic departure from his previous view that inflation expectations were well-anchored and that enough was being done to get Europe back on a sustainable growth track. It also represents a major departure from the German stance that is highly skeptical of QE as a policy tool. When asked if the large-scale purchase of sovereign bonds (i.e. as pursued by the U.K., the U.S. and Japan) is illegal (the German viewpoint), Mr. Draghi has responded in a rather pointed way that not reaching the ECB's mandate of inflation close to, but under 2%, also is illegal.

So far, however, only modest progress has been made in increasing the ECB's assets; the balance sheet had been bouncing around just north of the €2 trillion mark in recent months, until registering a jump in the final week of 2014 to €2.15 trillion. The first two tranches of TLTRO offerings recorded a disappointing level of bank participation. Analysts also believe that the market for European covered bonds and asset-backed securities is too small to reach the ECB's stated goal of a €1 trillion balance sheet expansion. Hence, investors continue to speculate whether sovereign bond purchases will take place sooner or later. We think government bond buying will indeed happen, and that it will be sooner rather than later, perhaps with an announcement coming as early as the January 22 meeting of the central bank's Governing Council.

We believe Japan's doubling down on its own QE efforts at the end of October was a seminal event. It could even be viewed as the first salvo in a currency war. As countries and common-currency zones continue to face domestic economic headwinds and declining inflation rates, policymakers are seeking to boost economic growth via exports. In a global economy that is growing sluggishly, however, this stratagem becomes a zero-sum game. Until the end-of-October monetary surprise by BOJ Governor Haruhiko Kuroda, the excitement surrounding Abenomics had faded substantially. Not only were structural reforms lagging, but the initial boost to the economy from the previous round of depreciation between October 2012 and May 2013 had been completely upended by last April's boost in the country's consumption tax.

Exhibit 9 shows that the Japanese currency actually drifted higher against the euro in value (viewed in the chart as a move down since each euro buys fewer yen) through much of 2014. It then experienced a sharper appreciation in September as the ECB cut policy rates and announced its own version of QE. This was particularly worrying for Japanese policymakers, since the country's trade deficit had been worsening over time, and there had been only a modestly positive export response in volume terms to the yen's previous weakening. The doubling-down of QE in Japan, combined with lingering uncertainty in recent months over the ECB's ultimate response, has once again pushed the euro appreciably higher against the yen. As shown in the same exhibit, the balance sheet of the BOJ continues to expand rapidly versus that of the ECB.

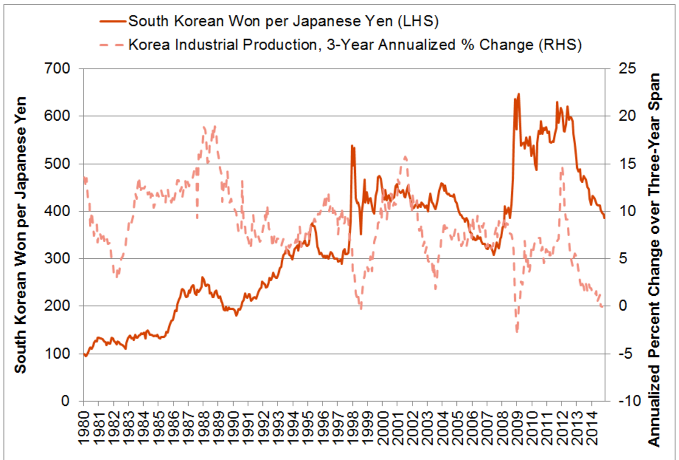
Exhibit 9: Rising Sun, Setting Yen



Source: Bank of Japan, European Central Bank, WM/Reuters, SEI

Other countries are now showing the effects of collateral fall-out. Take South Korea, for example. Excluding the 1997-98 and 2008-09 crisis periods, Korean industrial production (shown in Exhibit 10) is running at its slowest pace since before 1980, measured over a three-year annualized span. Korea's industrial output growth rate tends to accelerate as the won depreciates against the yen (1982-87, 1992-95, 2009-2011) and moves down as the won appreciates (1989-91, 2001-07, 2012-2014). Note that the expansion of the Japanese central bank's balance sheet beginning in 2012 relative to that of the Bank of Korea has been matched closely by the yen's depreciation against the won. This is very similar to what we have seen in the USD/euro vs. Fed/ECB relationships.

Exhibit 10: Won and Lost

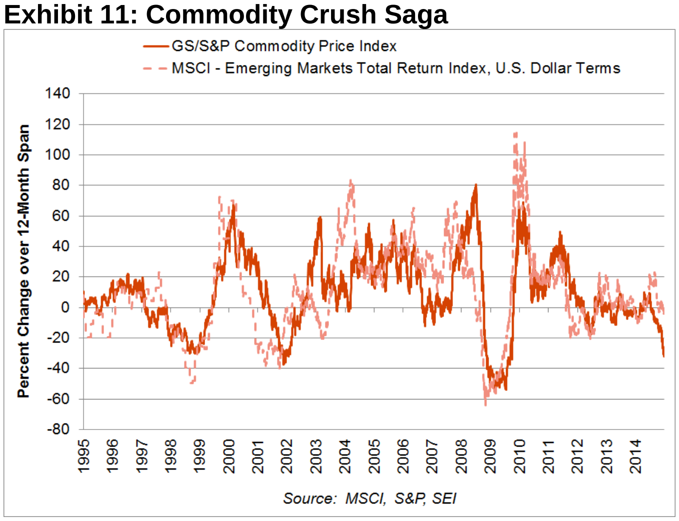


Source: International Monetary Fund, WM/Reuters, SEI

We only highlight Korea because it is an important trading competitor with Japan. In recent weeks, the Swiss National Bank has lowered its rate on bank funds deposited at the central bank into negative territory in order to prevent an appreciation of the franc against the euro. Meanwhile, China has allowed the renminbi to depreciate against the dollar, a potentially significant change of trend versus the steady appreciation that had taken place since 2010.

Another consequence of the currency wars and strong-dollar trend has been a breath-taking decline in commodity prices, centered most recently in the energy complex. Of course, the dollar's decline is just one factor behind the slide. Weak global growth, especially in China, is another one. The increase in the production of many commodities—the lagged response to strong pricing and optimistic demand forecasts prior to 2007—is a third. The strong dollar/weak commodity combo has had a predictably harsh impact on emerging-market equities, as seen in Exhibit 11. We would point out, though, that there is a bifurcation of performance. Exporters of raw and semi-finished commodities (Brazil, Malaysia, Colombia, Peru, Chile) have seen their currencies and stock markets come under pressure, while consumer nations and producers of higher-value finished goods (India, China, South Korea, Taiwan, Israel) have tended to hold up better. Russia, of course, is in a world of its own, given its dependency on oil and the impact of sanctions on its economy. The ruble has collapsed. One dollar now buys about 60 rubles (at the peak of the currency panic in mid-December the ruble was selling at 80 to the dollar) versus 34 as recently as July. The Russian central bank has raised interest rates to 17% and has been forced to defend the ruble by selling about one-quarter of its currency reserves.

Exhibit 11: Commodity Crush Saga



Although concern is being expressed by some stock-market analysts that a strong dollar will weigh on the U.S. equity market, history suggests the opposite: Buoyant equity markets and a strong currency regime go hand-in-hand. Remember Robert Rubin's mantra when he was Bill Clinton's Treasury Secretary: "A strong dollar is in the interests of the U.S."

We seem to have come full circle. Exhibit 12 shows the positive correlation between the dollar's trade-weighted value[1] and the forward P/E on the S&P 500. Such a relationship makes sense. The U.S. imports more than it exports and its domestic consumer-oriented, service-based economy is much larger than its trade-sensitive sector compared to most other countries. In addition, dollar strength creates, and is reinforced by, investment inflows that find their way into U.S. financial markets. The U.S. may be the cleanest dirty shirt in the laundry bag, but it remains a magnet for capital in a return-hungry world.

Exhibit 12: Don't Fear a Strong Dollar

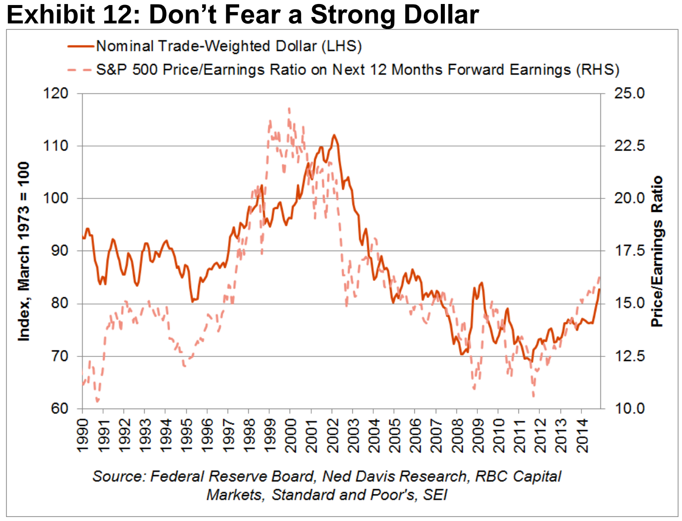
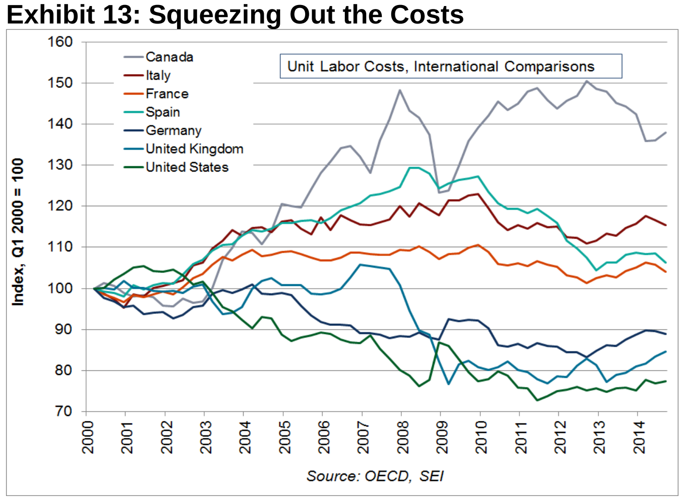


Exhibit 13 highlights another reason why the U.S. can sustain additional increases in the dollar's trade-weighted value. Unit labor costs in the U.S. have moved steadily lower since the early 2000s. They have become especially competitive against Canada, its largest trading partner.

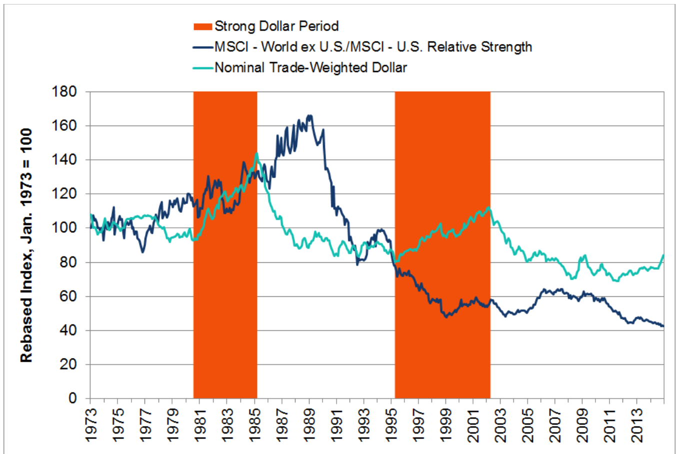
Exhibit 13: Squeezing Out the Costs



[1] The trade-weighted dollar index measures the value of the U.S. dollar relative to other currencies.

Although the strengthening of the greenback will have a negative impact on the earnings of U.S. exporters, lower import costs (especially for energy) should provide an offset. In short, a strong dollar should not spell the end of the multi-year bull market in U.S. equities. That said, it is possible that stock markets elsewhere in the world could perform better, given their relative cheapness. Some of SEI's global managers are shifting in that direction. Even hedged for currency fluctuations, the U.S. market tended to do relatively well versus the MSCI World ex U.S. Index during the last period of prolonged dollar strength in the 1995-2002 period, as Exhibit 14 shows.

Exhibit 14: Will the Dollar Help or Hurt Global Relative Performance?



Source: Federal Reserve Board, MSCI, SEI

Looking Out for the Bumps in the Road

In sum, our tendency is to remain optimistic regarding global equity markets. Since the U.S. sports a higher valuation on a number of metrics, we are shifting to a more balanced view of relative performance. The U.S. may still do well, but some other markets might do better. We think Japanese equities, for example, have great potential. Monetary policy will remain aggressively expansionary. The collapse in oil prices is a godsend for Japanese consumers and businesses that had been hit badly by the previous hike in prices caused by the sharp depreciation in the yen. Although the government's finances are a longer-term concern, the recently announced 18-month delay in the next consumption tax hike (originally scheduled for October 2015) should improve consumer confidence.

The recent snap-election that reaffirmed Prime Minister Shinzo Abe's power in the lower house of the Japan's legislative branch (the Diet) also increases the possibility of wide-reaching economic reforms and agreement on the Trans-Pacific Partnership (TPP) trade pact. It is disappointing that the agreement has taken so much time to come to fruition. Nonetheless, the stars are aligning for a successful outcome. Not only can Prime Minister Abe claim a mandate to push through the more controversial parts of the agreement through the Diet, but the other big roadblock—U.S. congressional reluctance to give President Obama fast-track negotiating authority—has most likely been dismantled thanks to the change of control in the Senate and the Republicans' favorable view on the issue. Lower trade barriers to agricultural products, as well as other products and services, would be a boon for Japanese consumers. Since the 12 participants in the TPP account for some 40% of the global economy, the free-trade agreement has the potential of boosting growth along the Pacific rim.

In general, we think developed international markets should provide more consistently positive performance in 2015, given the tailwind of lower energy prices, more accommodative monetary policies and some easing of the fiscal constraints that have hurt the eurozone in particular. Of course, to some extent, markets will still react to developments in the U.S. The first Fed policy rate hike in the U.S. will be an important event. However, as we've pointed out previously, the initial stages of a Fed tightening cycle do not usually mean the end of the bull-market run. It could slow the bull down for a couple of months, though. According to Ned Davis Research, the Fed has embarked on a rate-tightening cycle 19 times since 1928. The average gain in the S&P 500 price-only index one year later has amounted to 8.6%, slightly better than the historical average over all periods of 7.2%. It still seems that "buy on the dip" is the appropriate strategy for the coming year.

Of course, every year has its surprises, good and bad. Since our view is generally positive, we need to consider what can go wrong. Top of the list, in our opinion, is a faster response by the Fed to signs of better economic growth. There is a rather large gulf between our (not to mention most other investors') expectations for a very slow normalization of the Federal funds rate versus those of the Federal Reserve's decision makers. Federal funds futures imply a funds rate of 0.6% by year-end 2015 and 1.5% by year-end 2016. In contrast, the Fed's Federal Open Market Committee (FOMC) members forecast a median funds rate 1.125% at the end of 2015 and 2.5% at the end of 2016. Although the market's projections are probably closer to the views of Federal Reserve Chair Janet Yellen and the other doves who are still in the majority of voting FOMC members, an economy that runs hotter-than-expected will create pressures to step up the pace of rate hikes.

In similar fashion, the battle within the ECB between President Draghi and the German-led hawks will be critical to our outlook on Europe. The euro's decline against the dollar was turbocharged more by Mr. Draghi's rhetoric than actual action. Currency traders have piled into the short-euro trade in the belief that the ECB will deliver on an aggressive version of QE that includes the purchase of sovereign bonds early in 2015.

If he does not carry the day against the Bundesbank bloc within the ECB, the reaction in the currency market could be severe as those short euro trades are reversed. It could also have a decidedly negative impact on European equities as deflation fears worsen.

In emerging markets, China remains our perennial concern. Although investor sentiment toward the country has improved recently owing to an easing in policy interest rates and the depreciation of the renminbi against the dollar, the hangover from the 2008-2009 lending boom remains. Property markets remain very shaky, and we do not believe that the deleveraging of the financial system has gone far enough. One could make the argument that the prolonged soft landing of the Chinese economy in recent years could get a tad harder in 2015. Further slowing in China's growth would keep intact the downward pressure on commodity prices. Although emerging countries are a disparate group, further deterioration in China next year could act as a drag even for those economies, like India's, that benefit from the oil price decline.

Finally, keep an eye on politics. In the U.S., the Republicans have taken control over the Senate, creating a new dynamic between the Obama Administration and the Congress. While we do not expect much agreement on most matters, the passage of fast-track negotiating authority would be an important milestone. Failure to proceed would torpedo the TPP talks and remove one of the supports for our positive view on Japan and the Pacific Rim as a whole.

While political dysfunction in the U.S. has become the norm, the United Kingdom may be entering its own dysfunctional phase. We received a taste of that in 2014 with the Scottish referendum and the rise of the United Kingdom Independence Party. The parliamentary elections scheduled for May 2015 could well deepen the political confusion. It appears likely that Conservative Party support will ebb as voters on the right of the political spectrum opt for its anti-immigrant UKIP opponent. The Labor Party, meanwhile, faces evisceration of its presence in Scotland owing to the growing political power of the Scottish nationalists. The possibility of a hung parliament and the political uncertainty surrounding the run-up to the elections could well keep a lid on equity performance in the U.K. despite moderate improvement in economic activity and relatively low valuations.

And then there is Russia. President Vladimir Putin has kept Ukraine on the boil, periodic truces between the Ukrainian government and the Russian-supported separatists notwithstanding. One would hope that sanctions, the oil-price drop and the ruble's collapse would moderate Mr. Putin's adventurism, but that has not happened yet. Indeed, the Russian President's rhetoric has become more inflammatory, even reckless, lately. He continues to test the West's resolve by violating the waters and airspace of the Baltic and Nordic nations. A further ratcheting-up of tensions could elicit a risk-off response by investors, not just in Europe but possibly on a more global basis.

Strategy Positioning

Our equity investment managers appear to be moving away from a pro-U.S. growth view to one that favors Europe and select emerging markets, including India and China. Fixed-income portfolios tend to be short interest-rate duration, and they also have a yield curve-flattening bias in anticipation that an interest rate hike by the Federal Reserve will cause short-term interest rates to rise while longer-term rates see little change. Portfolios across asset classes generally remain tilted toward dollar strength.

U.S. large-cap equities can be described as modestly pro-cyclical, meaning that they can be characterized as a bet on the strength of the U.S. economy. They show a higher-than-benchmark market sensitivity (that is, a beta greater than 1). Portfolios also favor earnings momentum and are underweight defensive sectors. Although large-cap equity holdings are biased toward smaller size, this is more a function of active management than a tactical asset allocation decision. Small-cap funds, by contrast, have a larger-cap bias versus the index and an exposure to deeper cyclical stocks. Our U.S. managers still have a positive view based on earnings growth, although they see geopolitical risks increasing the odds of a disruptive event.

Global equity funds appear to be more aggressively positioned, overweighting small-cap stocks and exposed to momentum and volatility risk factors. Europe and emerging markets are favored over the U.S., the U.K. and Japan, although there is an off-benchmark position in select U.S.-listed names. Overweight sectors include semiconductors and equipment, electrical equipment and biotechnology. Underweight positions can be found in diversified financials, utilities, telecom services, consumer staples and fuel refiners. Managers are exposed to foreign exchange risk (underweight the yen, euro, Australian dollar and U.K. pound, overweight the Norwegian krone).

SEI currently favors momentum managers in the U.K., but value managers in Europe excluding the U.K. Quality-oriented stability managers are underweight in the portfolios. Cyclical sectors and non-bank financials are overweight, while defensive sectors (too expensive), banks (regulatory uncertainty), energy (too heavy a weight in the U.K. benchmark) and commodity stocks (uncertain outlook and poor momentum) are underweight. The market-wide equity view is mostly neutral, perhaps shading to the bearish side, relative to other geographies.

Canadian funds are exposed to growth and momentum factors and underweight dividend-payers. On a sector basis, they are underweight financials, energy, materials and interest-rate sensitive industries (real estate investment trusts, utilities). Overweight positions can be found among exporters, consumer staples, technology and defensive stocks. There is a relatively high cash position. The Canadian market continues to work through the implications of the drop in oil prices and a lowering of corporate profit targets going into year-end. Market sentiment is decidedly bearish.

In Asia, investment managers have turned more optimistic on Japan despite the weak economic data. They believe corporate fundamentals will remain healthy thanks to the weakening yen, and they see improvement in corporate governance and capital efficiency. They are overweight the technology and industrial sectors and underweight consumer staples. Growth is the most important exposure, although managers are maintaining a balanced mix. Outside Japan, China is the largest country overweight versus benchmark and Australia (exposure to falling commodity prices) is the largest underweight. Managers continue to underweight defensive sectors (Australian banks, high-yielding stocks) owing to high valuations. Technology and industrial stocks are overweight in portfolios.

In emerging markets, the bulk of risk reflects the wide divergence of performance across countries, sectors and companies. There is significant country risk exposure, however, with an overweight to India and an off-benchmark exposure to U.S.-listed companies. Korea, Malaysia and Qatar/United Arab Emirates are underweight in emerging-market portfolios. Style exposures include an overweight to small cap, underweight to value and overweight to momentum and volatility. Emerging-market managers are wary of geopolitical risks, but are becoming more positive on China's economic prospects and are increasingly hopeful that India will see an accelerating pace of reforms as it pursues a broad-based agenda to encourage foreign investment, increase infrastructure spending, and accelerate jobs growth.

In fixed income, SEI's managers in the U.S. and elsewhere are adhering to a common theme of short duration to their benchmarks in anticipation of a rising interest-rate trend. They also tend to be overweight credit, positioned for a flattening of the yield curve, and expect a continuation of U.S. dollar strength versus most other major currencies.

In the U.S., our core fixed-income managers exhibit a curve-flattening bias, underweighting the shorter-end of the yield curve (one-to-five year maturities) and overweighting longer-term (30-year maturities). Global fixed income portfolios also have a shorter-than-benchmark duration in both U.S. and U.K bonds. Significant risk positions can also be found in currency positioning, expressed by bearish bets on the euro, the yen and the Canadian dollar against the U.S. dollar. Within the corporate bond space, the U.S. and banks are overweight. Opportunities are less abundant than in previous years, but can still be found in duration, country selection and foreign exchange positioning.

In the U.K., our fixed-income managers also are short benchmark duration in both U.S. and U.K. bonds, and are positioned for a flattening of the yield curve in the U.S. Credit exposures include overweights to corporate and high-yield bonds, as well as banks. Our managers expect U.K. government yields to move upward at a slow and steady pace. The extra yield in the credit positions should enhance total returns. Although there is not a huge amount of additional spread compression that can be wrung out of corporates, fundamentals and demand/supply technicals remain supportive.

Canadian bond managers also are short their benchmark duration and expect a flattening yield curve. They are overweight investment-grade corporate credit. They also are significantly overweight in lower-tier BBB and A rated credits and have an off-benchmark position in Maples (the Canadian dollar debt of foreign issuers). Both Federal Government of Canada (non-agency and agency) and Provincial Sector (mainly debt-burdened Ontario and Quebec) are underweight. Canadian managers expect absolute performance to be limited owing to the current low interest-rate environment and compressed credit spreads. The oil-price collapse has pushed any increase in the Bank of Canada's policy rate further into the future. In fact, markets appear to be assigning an increased (but still low) probability of a rate cut within 12 months.

U.S. high-yield managers have become more defensive, further shortening their portfolios' duration against the benchmark. Credit-quality positioning continues to overweight CCC and B rated debt versus BB credits. Exposure to bank loans and structured credit has been increased in recent months. The collapse in oil prices is having a meaningful impact on expectations for the asset class, given the high concentration of energy-related paper. According to estimates provided by J.P. Morgan, if oil prices were to remain at their current levels, the default rate of energy issuers could exceed 20% in 2016, with an annual average default rate of 13.3% over the 2015-2017 timeframe. The default rate for the asset group as a whole could average 4.5% versus a base case of 2.5%.

Emerging-market debt managers are underweight interest-rate duration and overweight spread duration, investing in a selection of countries such as Venezuela and Russia that have significant yield advantage. Funds are underweight local bonds, currencies and external debt, and carry a relatively high position in cash and corporate bonds. Local bonds and currencies had been overweight earlier in the year, but these positions were gradually reduced.

Corporate exposure is concentrated in high-yield names in Mexico, Brazil, China, Colombia and Russia. On a country basis, the biggest active bond positions are found in Indonesia, Venezuela, Mexico, Turkey and Chile. Underweights include Poland, Philippines, South Africa, Peru and Singapore. While dollar-denominated debt has put in a resilient performance at the asset-class level, local-currency debt has been hard hit during the second half of the year. Our managers expect emerging debt to be supported by the trend toward easier global monetary policies. Interestingly, the spread of emerging-market debt over U.S. high yield is back to pre-taper (early 2013) levels, when Russia and Brazil are excluded from the calculation.

Within alternative strategies, the equity hedge and event-driven space have the greatest weights in the portfolio. Alpha generation in the former strategy has been hurt by the sharp sell-off in certain energy infrastructure names. However, most of the underperformance has been driven by idiosyncratic company-specific factors. The sell-off in energy stocks also has been a drag on the event-driven portfolio. Our managers remain positive on event driven/special situations strategies, however, since low borrowing costs and significant corporate cash balances should continue to be drivers for corporate activity for the foreseeable future. Opportunities can be found within distressed credit liquidations, restructurings and selected event-related credits. The energy sector, for example has become an area of focus as a distressed-debt opportunity. The relative value portfolio also has been challenged by the sharp sell-off in the energy market, which hurt long/short credit positioning. Structured credit managers, on the other hand, have partially offset these losses. With high-yield indexes materially underperforming over the past several months, our managers see value creeping back into the credit market. The last of our alternative strategies, tactical directional, has performed well lately by capitalizing on the weak commodities trend, strength in the U.S. dollar, and exposure to U.S. and Japanese equities.