

An Economic Thaw, but a New Cold War

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

The Portfolio Strategies Group recently released its first-quarter 2014 Economic Outlook. A summary of its conclusions is provided below:

- Equities have turned a bit more volatile this year—and for good reason. Disruptive cold and snowy weather during the first quarter has made recent economic data coming out of the U.S. statistics mills about as reliable as those that are made in China. The invasion of the Crimean peninsula by Russian troops has raised the specter of a renewed cold war. Throw in the longer run worries surrounding the political, economic and financial health of several emerging countries, and one might expect investors to go into permanent hibernation.
- Global stock markets bounced higher following a brief dip in the latter part of January, with the U.S. leading the way. The ability of equities to quickly overcome periodic stumbles (in the U.S. and other developed markets, at least) underscores investors' willingness to assume risk even when economic and geopolitical uncertainties are on the rise. The fact that pullbacks in developed equity markets remain brief and shallow suggests that the rotation out of cash and fixed-income assets and into stocks is still very much in play.
- Emerging-market equity, however, continues to underperform. Although emerging-market valuations are attractive versus the U.S. market (near decade-long lows), both political and economic factors have reduced our conviction that the value in emerging-market equities will be realized over the near term.
- Geopolitical concerns and a further easing of inflation pressures around the globe sparked a stronger rally in sovereign debt than we expected at the start of the year. However, performance has been good in the fixed-income areas our managers have been emphasizing, especially high-yield and dollar-denominated emerging-market debt. Since the yield on Treasury and investment-grade corporate bonds remain low relative to their own history and to inflation, we continue to expect more volatile assets (including equities) to outperform less volatile ones.
- In equities, the excessive investor enthusiasm in developed markets at the start of the year has eased; the negative sentiment toward emerging-market equity has not abated. Momentum strategies were quite successful in January and February but hit a road block in March. We are mindful that momentum-focused markets can become dangerous as participants crowd into the same trade and leverage up in an effort to improve returns.
- Stocks in Europe are well bid despite the tepid growth we mentioned earlier. There has been a shift in relative performance, with more domestically oriented sectors outperforming those that are export dependent. Our managers think this convergence play has more to go. With the exception of low-volatility strategies, our U.K. and European managers favor industrials, technology and consumer discretionary sectors and are underweight consumer staples. Valuations are not stretched, and there is conviction that global growth will accelerate.
- In alternative strategies, managers are adding to their equity exposure as the environment improves for bottom-up stock picking. Short positions, however, are not hurting performance this year because the market is less directional. Activist investing and mergers-and-acquisition strategies also are contributing to performance. Opportunities in the event-driven space are expanding and transactions are getting bigger. In fixed income, alternative strategies are more balanced, with yields and spreads not offering any big opportunities, in our managers' opinions. Most of the emphasis is on structured credit, such as commercial and residential mortgage-backed securities.

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

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice. This information is for educational purposes only.

There are risks involved with investing, including loss of principal. Current and future portfolio holdings are subject to risks as well. Diversification may not protect against market risk. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Narrowly focused investments and smaller companies typically exhibit higher volatility. Bonds and bond funds will decrease in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments.

Information provided by SEI Investments Management Corporation, a wholly owned subsidiary of SEI Investments Company. Neither SEI nor its subsidiaries are affiliated with your financial advisor.