COMMENTARY

Inflation Re-Awakened

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June 27, 2008

Surging food and energy prices and talk of a US recession have investors wondering whether the specter of 70s-style stagflation, surging inflation coupled with a slowing economy, is coming back to haunt them. If stagflation is returning, thankfully it looks different from the 70s experience this time around. And not just for the lack of huge sideburns and bell bottoms, but for economic reasons as well.

Not all inflation is created equal

The main similarity between the 70s and the current environment is surging oil prices. In the 70s, however, oil had a much bigger influence, compared to today's more service-oriented developed economies, and eventually led to double-digit inflation. This seems unlikely in the more service-oriented developed economies of today, as oil prices shouldn't feed through to as many other areas. Developed economies of today are also generally seen as being more able to adapt to price shocks, given deregulation of financial markets, technological developments and other general improvements in productivity.

For investors in general, inflation is unwelcome because it erodes the returns they get from their investments. The higher inflation is, the lower the purchasing power of those future returns will be. Using the example of US inflation, at its peak of 14.8% in April 1980, an investor in the US would have needed an annual return of the same magnitude just to break even in terms of the purchasing power of their investment. In other words, this investor would need $114.80 to buy the same goods and services that would have cost $100.00 a year earlier.

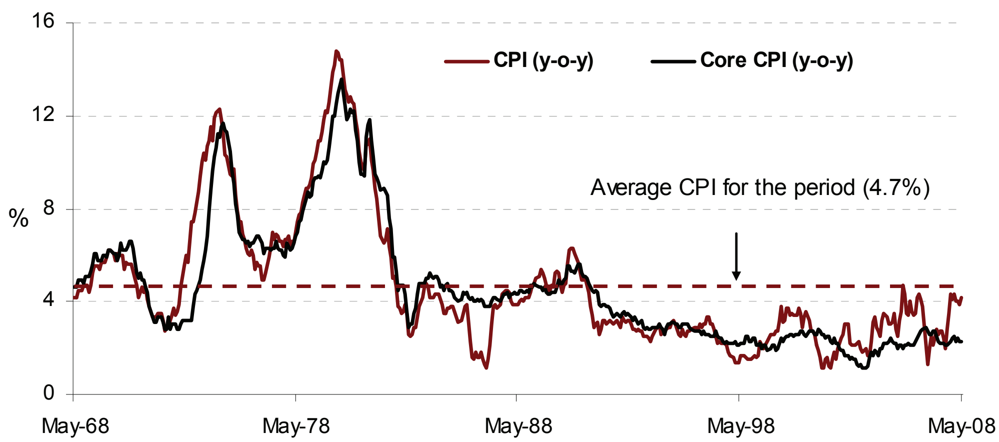
There are two basic kinds of inflationary pressures, referred to by economists as "cost-push" and "demand-pull." The latter is brought about by rising consumption -- typically during a period of economic expansion -- and is commonly referred to as "too much money chasing too few goods." Cost-push inflation arises when the cost of imported goods and services rises and there is no substitute. The rise in oil prices in the 1970s is considered by many economists to have been the root cause of high inflation during that period. Increases in the cost of oil led to increases in many other goods, causing a feedback loop of spiraling wages and prices as inflation expectations got built in. Because this happened in tandem with slowing economic growth, both bond and equity investors suffered from bouts of heavy selling.

Various broad measures of inflation have been turning higher around the globe in recent months, led by surging food and energy prices. The most commonly used indicator, the consumer price index (CPI), measures the price of a basket of goods and services that would be purchased by the typical household. The percentage change in the CPI is a measure of inflation. Taking the US as an example, the year-on-year change in CPI was 4.20% in the latest reading for April, near a 3-year high. However, that compares with a peak of around 14% in April 1980.

An alternative measure, core CPI -- which excludes volatile food and energy prices -- has remained relatively muted; registering a 2.3% year-on-year gain in the latest reading. This suggests that surging food and energy prices are so far not feeding into other goods and services (see Chart 1 which compares changes in US CPI and core CPI). As can be seen from the chart, core CPI has tended to be more stable than headline, or general, CPI post the 1970s.

Still, when it comes to measuring the impact of rising prices on purchasing power, it's the overall level of inflation that matters. Whatever the type of inflation, it erodes the value of the principal on fixed-income assets, and makes interest paid on that principal less attractive. In theory, equity investors would fare much better in an environment where strong growth and low unemployment were the causes of inflation, because company profits would rise along with inflation. However, when inflation occurs in an environment of weak growth and rising unemployment -- such as currently exists in the US and other major developed countries -- companies will generally be unable to push on their increased costs. Employees will also find it more difficult to demand higher wages.

Chart 1



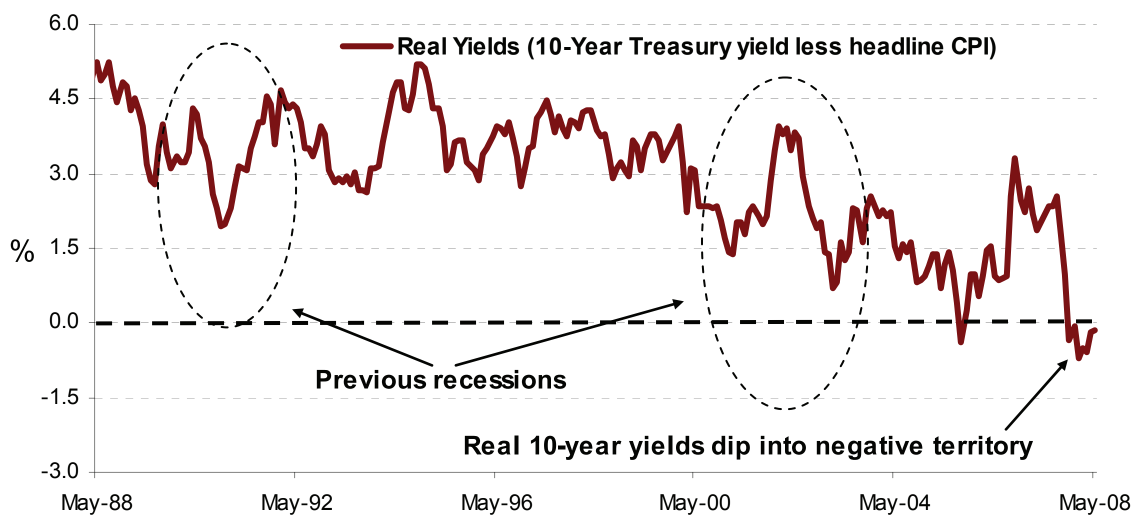
Source: Bloomberg

No clear historical link between inflation levels and market returns

In the early stages of the current credit crisis when investors' aversion to risk was at its highest, government bonds were in strong demand because they were the least likely to experience a default. But this drove yields (interest paid), which move inversely to prices, to well below the rate of inflation. Such negative real yields (adjusted for inflation) mean that investors in these securities are losing ground in terms of their purchasing power. As inflation concerns began to take on a greater prominence, government bonds experienced a sharp sell-off, driving yields back toward the rate of inflation (see chart below).

However, should high inflation persist, current yields are still not offering protection against it. On the other hand, the low level of yields compared to inflation could also imply that the consensus among investors is that a slowing economy will lead to lower inflation in the months ahead. The more worried investors are about future inflation, the greater the yield they would tend to demand from bonds maturing further in the future. Given the difference between 2-year and 10-year yields on US Treasuries was 1.42 percentage points at the end of May 2008, compared with an average of 0.87 over the past 20 years, this would suggest future inflation is currently seen as a threat. Yet 10-year yields, at 4.06% as of the end of May 2008, were still below the latest CPI reading of 4.2% year-on-year inflation.

Chart 2



Source: Bloomberg

The yields on corporate and other non-government bonds, however, are offering higher spreads over Treasuries than they have in many years. For example, the additional yields available for AAA-rated corporate bonds (the highest credit quality rating) are close to a full percentage point, surpassing the previous peak reached in the wake of the corporate scandals of the early 2000s and the raft of defaults that followed from the likes of Enron and WorldCom. Because they have already been heavily sold amid the credit crisis and prices already reflect expectations of a substantial increase in defaults, many investors are currently seeing value in corporate securities and securitized debt markets.

Returns from equities are expected to outstrip fixed income over the long run (the payoff for taking on additional risk). However, equity returns are also more volatile and therefore subject to greater risk of loss over shorter time periods. While the stock market has shown some tentative signs of bottoming, the outlook remains uncertain.

Looking at the example of the US in the late 1970s to early 1980s, and the impact of high inflation and slowing growth on stocks and bonds, there were dramatic variations in the returns of each asset class from year to year. While inflation-adjusted returns for the Lehman US Aggregate Index turned out to be negative for most years, investors who had abandoned bond markets would've missed out on a striking 32.64% gain for the index in 1982 as inflation slowed. Over the entire period from 1976 through 1982, inflation-adjusted returns were actually better for bonds (Table 1).

Table 1

Impact of 1970s Inflation on Annual Returns for US Stocks & Bonds

	S&P 500	Lehman US Aggregate	US CPI (annual %)	S&P 500 Inflation-Adjusted	Lehman US Agg. Inflation-Adjusted
1976	19.1%	15.6%	6.1%	13.0%	9.5%
1977	-11.5%	3.0%	6.5%	-18.0%	-3.4%
1978	1.1%	1.4%	8.5%	-7.4%	-7.1%
1979	12.3%	1.9%	11.3%	1.0%	-9.4%
1980	25.8%	2.7%	12.2%	13.6%	-9.4%
1981	-9.7%	6.3%	9.5%	-19.3%	-3.3%
1982	14.8%	32.6%	4.5%	10.2%	28.1%
High	25.8%	32.6%	12.2%	13.6%	28.1%
Low	-11.5%	1.4%	4.5%	-19.3%	-9.4%
Average	7.4%	9.1%	8.4%	-1.0%	0.7%

Source: Datastream, Lehman. Prior to 1976, Lehman US Aggregate Index did not exist.

Sticking to an asset allocation aligned with long-term goals

Research conducted by SEI's Gil Beebower in 1986, in conjunction with Gary Brinson and Brian Singer, indicated that asset allocation policy is the overwhelmingly dominant contributor to investor returns. In fact, according to this research asset allocation accounts for over 90%, compared with around 5% for security selection, about 2% for market timing and about 2% for other factors. Other subsequent research has also led to similar conclusions regarding the dominance of asset allocation, though to differing degrees.

SEI believes that decisions about asset allocation should be aligned to clients' long-term goals, and not driven by cyclical changes in the economy and markets. Our expertise lies in the areas of manager selection and long-term, strategic asset allocation. Tactical decisions, whether based on views on the economy or otherwise, are left to the underlying managers in the funds. This will lead to their being either overweight or underweight in the different segments of the fixed income or equity markets based on their views.

The managers across SEI's equity funds in general are underweight global financials and underweight in the energy and industrials sectors. This suggests some concern over the outlook for global economic growth and the perception among some of the managers that oil prices could suffer a correction after their steep gains of late.

Where will inflation go from here?

With regards to the inflation outlook, there tend to be two main camps. In the first there are those who believe weak demand and rising unemployment in the US and other industrialized countries will put downward pressure on prices. While this is the more sanguine view on inflation, it is also coupled in most cases with greater pessimism regarding the outlook for growth. Generally speaking, the slowing inflation camp believes the US economy in particular will suffer a prolonged period of weak growth, dragging the rest of the globe along with it.

An opposing viewpoint on inflation, and more optimistic view on the prospects for the US and global economies, is that prices will continue to march higher amid rising overseas demand for cheaper US exports and US assets. According to this view, as the dollar remains weak or weakens further, the current glut of savings in Asia and the Middle East will be recycled into rising consumption (particularly of US goods, services and assets). Meanwhile, an appreciation of the Chinese yuan and the currencies of other key developing countries will add to global inflationary pressure as prices for their exports rise in foreign currency terms.

Some of this recycling has already been seen as Asian and Middle East investors have stepped in to buy up stakes in global investment banks that have found themselves in need of capital injections after writing off distressed debt. However, domestic consumption remains a much smaller contributor than exports to the overall economic growth of these countries, and may struggle to make up for the lack of demand coming from the US and other developed countries.

During this time of heightened uncertainty over the outlook for inflation and growth, SEI believes the best approach continues to be for investors to stick with a strategic asset allocation aimed at reaching long-term goals.

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Will joined SEI's London-based investment team in August 2006, having worked in a similar capacity for Invesco Perpetual from 2003. Prior to working in investment communications, Will spent 5 years as a currency analyst at the London offices of MMS, a unit of Standard & Poor's, and worked as a financial journalist for Bloomberg News for 8 years in their London and Princeton, NJ offices. Will holds a BA in Economics from Colgate University.

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