

Perspectives

July 17, 2009

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The strong performance delivered by global financial markets during the second quarter of 2009 reflects the continued accumulation of evidence that the economies of the world, including that of the United States, are stabilizing. Fiscal and monetary policy have succeeded thus far in alleviating some of the financial stresses, and it is reasonable to expect renewed growth – albeit modest – as early as the second half of this year. Investment returns from equities, corporate bonds, commodities, and emerging markets should continue to exceed those of risk-free Treasury securities and cash. Nevertheless, lower home prices, rising unemployment, lingering tightness in the credit markets, and vacillating consumer confidence are likely to cause the recovery to be slow and uneven, and investors will need to maintain a longer-term perspective on the markets. The prospects of inflation and a plummeting dollar have received increasing attention over the last few months, but neither inflation nor a weaker dollar is an immediate threat to the recovery.

REVIEW

During the second quarter of 2009, the financial markets continued the rally begun on March 10th. Energized largely by welcome signs of stabilization and improved investor confidence, the advance was an upsurge. The most significant de-

cline in the Dow Jones Industrial Average during the quarter was a 3.6% drop that occurred in late April.

By the middle of June, however, the rally stalled, as investors paused to consider whether the markets had exceeded the levels justified by their underlying fundamentals. Yet, even with the moderate pullback that occurred in late June, the overall positive direction of the quarter was undeniable. It was the best quarter for the Dow since 2003.

U.S. Equities. The Dow gained 12% for the quarter, trimming its losses to 2% for the year and to 40% from its historic peak on October 9th, 2007. The S&P 500 Index fared even better, closing ahead 15.9% for the quarter and a positive 3.2% for the year.

Financial stocks led the rally, as capital again became available to bolster balance sheets. Energy and materials stocks also performed well, with investors expecting renewed demand for raw materials to feed the improving emerging-market economies of the world. Technology stocks, too, outperformed, on the theory that technology companies will profit from the attempts of businesses to improve efficiency and productivity. As a result, the technology-focused NASDAQ Composite Index rose

20.3% during the second quarter, bringing its total gains for the year to 17%.

Even volatility levels improved during the quarter. The VIX volatility index, sometimes referred to as the “fear index,” ended the quarter just above 26, just off its lowest levels since Lehman Brothers filed for bankruptcy protection last September. By contrast, the VIX exceeded 80 at times last Fall. The historic norm for the VIX is approximately 20.

U.S. Fixed Income. As fears waned and the overall trend of increased risk-taking continued, corporate bonds made dramatic gains during the second quarter. Investment-grade corporate bonds gained over 9% for the quarter, returning to levels not seen since the financial crisis began last September. Almost \$190 billion of investment-grade corporate bonds were issued during the quarter.

Municipal bonds also achieved positive results, returning approximately 0.7% in the quarter. Yet, as investors sought out greater risk, the value of risk-free Treasury securities correspondingly declined. Treasuries as an asset class lost 3.1% for the quarter, although most of those losses were attributable to longer-term Treasury securities. Treasury yields were again forced higher, with the yield on 10-year

Treasuries rising from 2.7% to 3.5%.

Risk premiums, or “spreads” – the incremental yield offered by corporate bonds over Treasuries – were nearly cut in half during the quarter. Spreads for investment-grade corporate bonds over Treasuries dropped from about 6% to 3.3%, approximately where they were before the Lehman Brothers bankruptcy.

Commodities. Optimism surrounding the prospects for a global recovery supported a strong rally in most commodity prices. The Dow Jones UBS Commodity Index rose 12%, erasing virtually all of the losses it had incurred since last November.

Oil finished the quarter up 41% at \$69.89 per barrel for its largest quarterly gain since 1990, more than doubling its lowest price of 2009. Much of this rise was attributable to forecasts of increased demand from emerging markets such as China and India.

Gold moved higher, but only by 0.5%. Gold was the beneficiary of risk aversion in past quarters, and, as investors assumed greater risk during the second quarter, the rise in gold prices was restrained. The price of gold closed the quarter at \$927.10 per ounce.

U.S. Dollar. Until the second quarter, the U.S. Dollar had made significant gains, as investors from around the world increasingly sought shelter in the world’s reserve currency. This trend was reversed in the second quarter, as investors moved into riskier assets such as equities and commodities. The Dollar was down 5.3% against the Euro and 2.7% against the Japanese Yen. It lost 14.7% to the British Pound on hopes that the British economy is stronger than previously thought.

International Markets. Increased investor optimism about global growth prospects continued into the second quarter, and emerging markets again outperformed their developed-country counterparts. As a whole, however, international markets were up: the Dow Jones World Index, excluding the U.S., was up 27.4% for the quarter (in U.S. Dollars).

The MSCI Emerging Market Index rose 34.7% for the quarter on the strength of continued optimism surrounding emerging markets. Benchmark indices in India and Brazil rose about 49.8% and 26%, respectively. China’s Shanghai Composite, which lost approximately 65% last year, gained 26% in the second quarter of 2009.

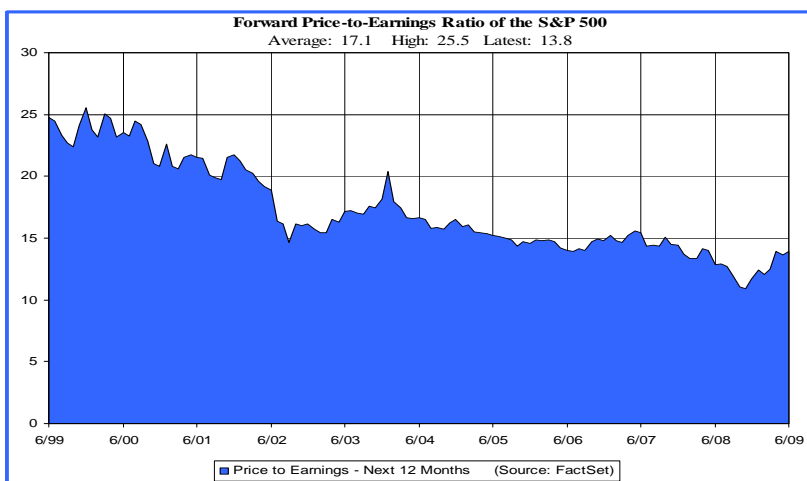
The MSCI EAFE (Europe, Australasia, and Far East) Index gained a slightly more modest 25.4%. Key indices in the United Kingdom (the FTSE 100) and France (the CAC-40) were up 9.8% and 15.8%, respectively, after seven straight quarters of losses. Germany’s DAX Index was up 18% after five straight losing quarters. Japan’s Nikkei Index gained 23% for the quarter, partially reflecting the extremes to which Japanese issues had fallen prior to the quarter.

ANALYSIS

U.S. and international economic data have become increasingly mixed over the last few months, potentially signaling an inflection point toward renewed growth, *i.e.*, the end of the recession. The recent performance of the forward-thinking equity markets could suggest a market-wide prediction to this effect.

In our view, the U.S. and other major economies *are* showing signs of stabilization and, in fact, are transitioning into a period of recovery and modest growth. Nevertheless, given the evidence currently on hand, the recovery, in all probability, will be less robust than many of the recoveries that followed other severe recessions. Accordingly, investors should be prepared for the likelihood of a lengthy, choppy, and somewhat diluted recovery process.

Equities, corporate bonds, commodities, and emerging markets are likely to outperform risk-free assets, but expectations for high returns over the next one to three years should be tempered. Current equity valuations are reasonable by historical standards. The S&P 500 finished the second quarter trading at a multiple of approximately 13.8 times projected operat-



ing earnings for the next 12 months, significantly less than the average multiple for the last 10 years, 17.1 (chart on p. 2).

This modest discount relative to historic norms is justified, given the lingering uncertainty surrounding the economy and the financial markets. Nevertheless, it also implies room for at least modest growth, even in light of downward revisions to earnings and the continuing lack of clarity.

Ultimately, fundamentals – notably earnings – will be required to drive equity prices higher. We now project overall average earnings growth of 5-10% per year over the next five years. At a minimum, that level of growth should be sufficient to generate average annual equity returns well in excess of the returns offered by Treasuries, assuming aggregate price-to-earnings ratios remain close to their historic norms. Lower average growth rates will place additional importance on effective security selection and the production of alpha.

Investment-grade corporate bonds also remain compelling, even after their 9% run during the second quarter. Investment-grade spreads are still somewhat high relative to their historic levels. In fact, the Federal Reserve has been purchasing Treasuries in order to keep Treasury yields low and *force* investors into riskier asset classes such as corporate debt and equities. With short-term rates close to zero and 10-year Treasury yields of 3.5%, the environment for holding equities and corporate debt is more favorable, and, conversely, the environment for holding Treasuries and cash is less favorable.

With regard to commodities, prices may retreat during the shorter-term after making such significant gains over the past quarter; but they also

offer longer-term upside, particularly as they are tied to the future growth and expansion of the emerging-market economies. In turn, the emerging markets themselves continue to offer an attractive risk-reward profile. Developing economies should grow faster than those of developed countries and are furthest removed from the epicenter of the recent financial crisis, the U.S. housing market.

Housing prices appear to be stabilizing, but the decline continues. There have been continued signs that home prices are now in the process of stabilization, an important prerequisite to a sustainable economic recovery. The S&P Case-Shiller Index of 20 major cities recently exceeded market expectations when it showed the smallest monthly price declines since June, 2008.

Other housing-related reports during the quarter were also positive. The National Association of Home Builders Housing Market Index, which is tied to builder sales and expectations, improved significantly during the quarter. Moreover, the National Association of Realtors recently reported that sales of existing homes increased in May, likely due to favorable affordability conditions and the first-time homebuyer tax credit. May's increase marked the first back-to-back monthly gain since September, 2005. The NAR also reported that total housing inventory at the end of May fell 3.5% to 3.8 million existing homes – a 9.6-month supply, down from a 10.1-month supply in April.

These are encouraging developments for the beleaguered housing sector, but, to be clear, we believe that home prices will continue to erode – albeit at a moderated pace – for several months before they are fully stabilized. In turn, falling

home prices will continue to be a challenge for the economy, increasing the level of shorter-term risk in the financial markets.

Unemployment continues to rise, but there are indications that job losses may moderate over the next few months. We have stated that the unemployment rate potentially could rise to as high as 11% given current conditions. Higher unemployment rates are another potential impediment to a full recovery, as they correlate to lower consumer spending, higher government spending, and lower gross domestic product.

Indeed, the Department of Labor recently reported that nonfarm payroll employment declined in June by 467,000 jobs and that the unemployment rate remained at 9.5%. Since the start of the recession in December, 2007, the unemployment number has increased by 7.2 million, and the unemployment rate has risen by 4.6 percentage points.

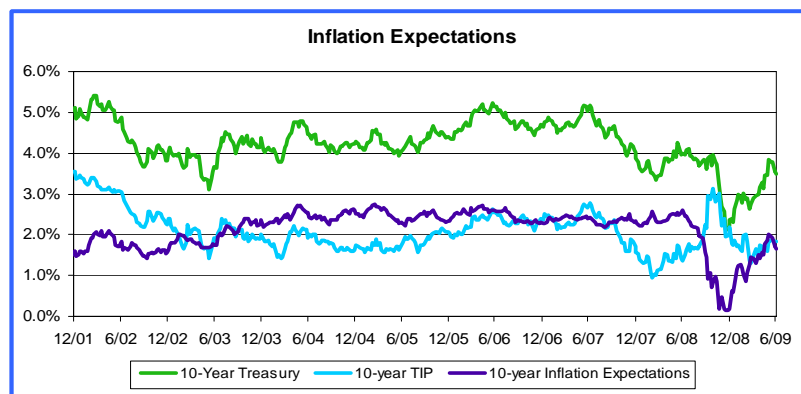
Yet, there are also signs that job losses will moderate over the next few months, including an increase in hiring plans within the small business sector, a significant decline in layoff announcements back to levels not seen since before the recession began, and even some modest improvement in the manufacturing sector. These indicators, as well as the promise of employment offered by government spending programs, provide reason for cautious optimism.

Inflation could become a longer-term concern, but it is not a current threat. With the U.S. Government running a budget deficit of close to \$2 trillion and the Fed injecting unprecedented sums of money into the economy, it has become fashionable to fret about the prospects of inflation. Our view is similar to that of Federal Reserve Bank President Janet Yellen, who

recently stated that deflation actually remains a greater threat than inflation in the near term. With high unemployment rates, housing prices still declining, and a general oversupply of goods, it is not surprising that the Consumer Price Index is down 1.3% from a year ago. Recall that only one year ago, oil was selling for \$145 per barrel, while gasoline cost \$4 per gallon.

We also agree with President Yellen that quantitative easing does not necessarily require that we have an inflation problem in the longer term. The Fed has the financial tools, the experience, and the resolve to tighten policy and withdraw stimulus whenever necessary. The Fed could raise interest rates and reverse the expansion of its balance sheet once the current crisis has ended. Additionally, future spending cuts and tax hikes, while politically unpopular, could avert an inflationary scenario.

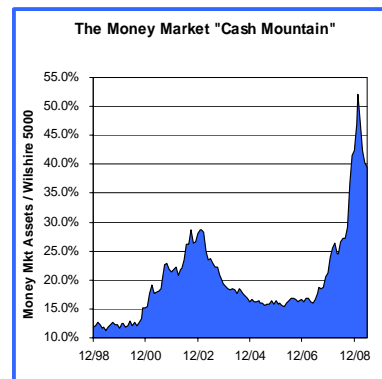
To be clear, we remain vigilant about inflation, and we will monitor events as they unfold, but we, like the Fed, are far more concerned about deflation than inflation for the next couple of years. The markets apparently agree with our view. The difference between the 10-year Treasury yield and the yield on 10-year Treasury Inflation Protected Securities (TIPS), as illustrated by the purple line in the graph below, shows inflation expectations of only about 2%, below pre-crisis levels.



The Dollar is in a state of decline, but that decline should be orderly and is not a current threat to the economy. For many of the same reasons that people are concerned about inflation, they are also concerned about the U.S. Dollar. Large deficits and unprecedented injections of money into the economy are unquestionably bearish for the Dollar. If the Dollar were to suffer a cataclysmic fall, then the economy would likely contract and the financial markets would decline. Fortunately, currency values are determined based on the *relative* economic conditions of the issuing governments. While the U.S. economy currently is not at its peak, it remains well ahead of most other international economies, and, therefore, the Dollar is not likely to fall dramatically relative to foreign currencies. In fact, foreign central banks continue to be purchasers of the Dollar, and no country has any real incentive to allow the Dollar to collapse, as the negative implications would be global. It is worth noting that the BRIC nations (Brazil, Russia, India, and China) recently resurfaced the idea of a multi-currency reserve system, but that notion is premature and, even if ultimately adopted, would take a great deal of time to implement.

Cash on the sidelines represents an opportunity for risk assets. Cash and cash equivalents continue to offer virtually no yield on

a nominal, pre-tax basis. Yet, U.S.-based cash as a percentage of U.S. equity market capitalization is at about 40%. This cash is earning very little or nothing, intensifying the pressure to seek a higher return on capital. Eventually, much of this cash will find its way into riskier assets, including equities, driving prices higher.



CONCLUSION

Economic and market conditions have improved in recent months, and, while it is premature to declare the end of the financial crisis and recession, there are encouraging signs of stabilization, which, in turn, could lead to renewed growth as early as the second half of 2009. Concerns about inflation and the collapse of the Dollar are premature, but concerns about declining home prices and rising unemployment are real. While progress has been made in the areas of housing and unemployment, further resolution must occur in order to sustain a prolonged economic recovery. In any event, when the recovery does occur, current conditions suggest that it will be prolonged and somewhat sluggish, forcing investors to have a longer-term perspective on the financial markets. Nevertheless, current valuations and conditions do favor remaining invested through diversified asset allocation strategies.