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## Perspectives

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*For the second straight quarter, the financial markets rewarded investors by delivering extraordinary returns. The markets are leading economic indicators, and it is reasonable to infer that they are enthusiastically predicting the demise of the strongest recession since the Great Depression. We generally agree with that prediction, but, while we believe that the recession is at or near an end, we also expect that the ensuing recovery will be slower and more uneven than other recoveries. Nevertheless, over the longer-term, equities as well as higher quality corporate and municipal bonds should continue to offer more compelling returns than those of risk-free assets such as Treasury securities and cash.*

### REVIEW

One year ago, shortly after the fall of Lehman Brothers, we wrote in our newsletter of “the ensuing emotional panic that has so distorted valuations and the basic economic principles of supply and demand.” A year later, continuing signs of economic stabilization, together with reports of corporate earnings in excess of discounted expectations, have bolstered the financial markets, leading to a second consecutive quarter of dramatic gains. In fact, the third quarter of 2009 was one of the strongest quarters in recent years.

**U.S. Equities.** The Dow Jones Industrial Average returned a total of 15.8% for the third quarter. The Dow’s quarterly performance was its best since 1998 and its third-best since 1939. By the end of the quarter, the Dow was up 48% from its March low and was ahead 13.4% for 2009, although it was still down 31% from its historic peak on October 9<sup>th</sup>, 2007.

The S&P 500 Index returned 15.6% for the quarter and also had one of its best quarters since 1998. The S&P 500 finished the quarter up 56% from its March low and ahead 19.3% for the year, but it remained down 32% from its 2007 high point.

The NASDAQ Composite Index returned 15.9% during the third quarter, bringing its total return for the year to 35.6%. By the end of the quarter, the NASDAQ was 64% ahead of its March low and 24.5% off its 2007 high; but it remained 58% off its 2000 all-time high.

**U.S. Fixed Income.** The recovery in the credit markets continued during the third quarter, and, predictably, bond investors were among the principal beneficiaries. Investment-grade corporate bonds gained over 8% for the quarter, with average yields falling to about 5%, making it more affordable for companies to borrow money by

issuing bonds. “Spreads” – the incremental yield offered by corporate bonds over Treasuries – fell for the second straight quarter. Spreads for investment-grade corporate bonds over Treasuries dropped to 2.35% from 3.3% at the start of the quarter.

Treasuries as an asset class managed a gain of 2.1% for the quarter on the strength of demand from abroad as well as purchases of Treasuries by the Federal Reserve. In turn, Treasury yields were driven somewhat lower. The 10-year Treasury yield fell from about 3.5% to 3.3% during the quarter, while the 2-year Treasury yield fell only slightly to about 1%.

Municipal bonds, which have been issued in record amounts this year in response to increased demand for quality debt instruments, also rose during the quarter. The Barclays Capital Muni Blend Index was up 3.9% for the quarter, bringing its 2009 gains to 7.3%.

**Commodities.** Commodity price movements during the third quarter varied widely. Overall, however, the trend was upward. The Dow Jones UBS Commodity Index rose about 4% for the quarter, bringing its year-to-date gains to 9%.

Having gained 41% last quarter, oil spent this quarter range-bound and rose only 1%, to \$70.61 per barrel. Its failure to break out of the \$70

range was a product of resistance caused by weakened demand and high inventories, coupled with support from a fragile dollar.

In contrast, gold, which moved higher by only 0.5% last quarter, gained 8.8% during the third quarter. Gold's strength was based on fears of inflation and a softening dollar. The price of gold closed at \$1,007.70 per ounce, up from \$927.10 at the start of the quarter.

**U.S. Dollar.** Until March, the U.S. Dollar had achieved significant gains during the recession, as investors increasingly sought shelter in the world's reserve currency. Since March, the Dollar's upward trend has been reversed, as investors have moved into riskier assets such as equities and commodities. For the quarter, the Dollar was down 4.1% against the Euro and 6.8% against the Yen. The British Pound, however, fared worse, losing 2.9% against the Dollar.

**International Markets.** Investor optimism regarding the prospects for a global recovery fueled the international financial markets during the quarter. Gains in developed countries accelerated relative to last quarter, while gains in emerging markets decelerated relative to last quarter, but returns nevertheless were healthy across most markets. The Dow Jones Global Index, excluding the U.S., was up 19% for the quarter.

The MSCI Emerging Market Index returned 20.8% for the quarter on the strength of increased confidence surrounding emerging markets. Notably, however, the same index had been up 34.7% last quarter. Benchmark indices in India and Brazil rose about 18% and 19%, respectively, but China's Shanghai Composite fell 6.1% in the third quarter, after having gained 63% during the first two quarters.

The MSCI EAFE (Europe, Australasia, and Far East) Index of developed economies returned 19.5% for the quarter. The United Kingdom's FTSE 100 was ahead 22%, France's CAC-40 gained 21%, and Germany's DAX Index was up 18%, each besting the major U.S. equity indices. Japan's Nikkei Index, however, returned only 2.3%, primarily due to uncertainty regarding its recent political shift.

#### ANALYSIS

The U.S. and other major economies are stabilizing and, in all likelihood, have been transitioning into a period of recovery and growth. Continuously mounting, broad-based evidence in support of this view has led most policymakers and forecasters to readjust their previously negative economic projections and join in the consensus call for renewed growth on a global basis. Indeed, the general debate has now shifted from whether and when a recovery will occur to what kind of recovery can be expected.

Many have argued that the "Great Recession" will be followed by an equally forceful "Great Recovery." This school of thought contends that the consensus outlook on the economies of the U.S. and other major economic powers has been overly harsh and that a strong, global expansion is likely to occur. Supporters of this argument point to accommodative monetary policy and unprecedented fiscal stimulus. They also note that, historically, there has been substantial correlation between the depth of a recession and the strength of the corresponding recovery. The President's Council of Economic Advisers has observed that "the three largest postwar recessions ... were all followed by rapid growth over the two years after the trough in GDP" and "deeper recessions are typically followed by more rapid growth."

In contrast, many argue that a swift return to sustainable growth is unsupported under current conditions. They point to high unemployment, a weakened consumer, and continued softness in housing. They worry that the U.S. economy could be headed toward some form of prolonged stagnation comparable to the conditions experienced in Japan after its real estate bubble burst in the late 1980s.

Given the current evidence, our view falls somewhere in between these extremes. We do believe that a recovery is underway, but we also expect that the recovery will be less robust and more inconsistent than many of the recoveries that followed other recessions.

**Monetary and fiscal policy should remain favorable until growth trends become sustainable.** On September 15<sup>th</sup>, after the Commerce Department reported that retail sales had climbed 2.7% in August, Federal Reserve Chairman Bernanke stated that the recession was "very likely over" and that "at this point ... we are in a recovery." He qualified his remarks, however, when he said that "even though from a technical perspective the recession is very likely over at this point, it is still going to feel like a very weak economy for some time, as many people still find their job security and their employment status is not what they wish it was."

Our view is similar, and it is premised on a number of factors, including accommodative monetary and fiscal policy. With near-term inflation in check, credit conditions still impaired, precarious conditions in the housing market, and consensus calls for low GDP growth, Fed rate hikes are not a foregone conclusion until the latter part of 2010 or early 2011. Much depends on the labor market. The Fed typically has waited at least 12 months and an

average of about 19 months after the unemployment peak before tightening its monetary policy. Of course, if longer-term inflation expectations rise, then the Fed may have to accelerate its plans to raise interest rates. For now, however, the Fed's official position is that rates will remain low for "an extended period."

Fiscal policy, too, should remain supportive. The Congressional Budget Office reports that the cyclically-adjusted federal deficit will have increased from 1% to 8.6% of GDP from 2007 to 2009. The resulting stimulus far exceeds the stimulus offered during prior recoveries. Certainly, future budget restraint is inevitable, but, as in the case of monetary policy, fiscal policy should remain accommodative until growth is sustainable.

**The housing sector is improving, but it remains precarious.** There have been continued signs that home prices are stabilizing, an important prerequisite to economic recovery. The S&P Case-Shiller Index of 20 major cities, as reported at the end of September, exceeded expectations by gaining 1.6% in July. The National Association of Realtors recently reported that pending sales of previously owned homes increased 6.4% in August, the seventh consecutive monthly increase. These are encouraging developments, but we are not yet prepared to conclude that home prices are stabilized. Further declines in housing prices would weigh on the economy.

**The labor market is showing signs of increased stability.** The unemployment rate rose slightly to a relatively high, but stable, 9.8% through September. Other employment trends point to improving conditions in the labor market. Unemployment claims have been falling; temporary employment has been stabilizing; and there has been

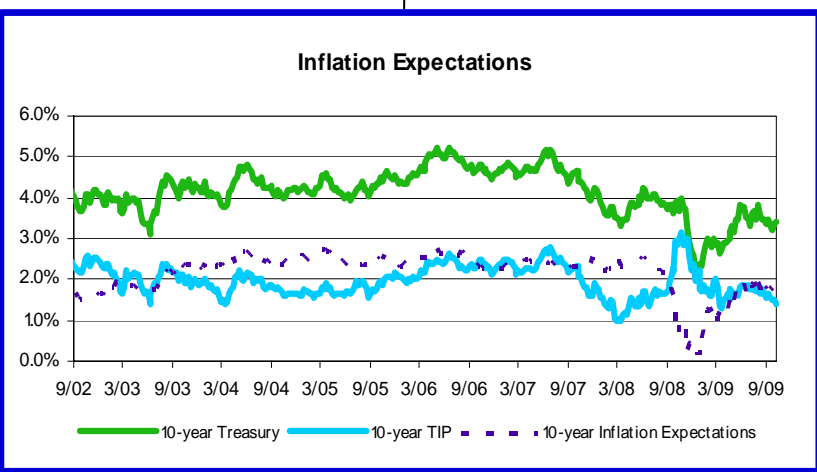
an increase in hiring plans of small businesses. These indicators, as well as the promise of employment offered by government spending programs, provide reason for cautious optimism. Nevertheless, it is too early to predict with any certainty that unemployment has hit its peak, as the labor market remains precariously weak by historical standards. A weakened but stabilizing labor market is consistent with our thesis of a restrained, uneven recovery.

**Inflation remains a longer-term concern but is not an imminent threat.** We continue to believe that *deflation* remains a greater threat than inflation in the near-term. High unemployment rates, a weak housing sector, and an over-supply of goods have kept inflation in check. Through September, headline inflation was -1.3% over the past year. Core inflation, which excludes food and energy, was up 1.5% over the past year.

The markets continue to agree with our view on inflation. The difference between the 10-year Treasury yield and the yield on 10-Year Treasury Inflation Protected Securities (TIPS), as shown by the dotted line in the graph below, shows inflation expectations of only about 2%, almost exactly where they were at the end of last quarter.

**The Dollar is declining, but that decline is likely to moderate.** Deficit spending, unprecedented stimulus, and low rate expectations have pressured the Dollar, causing it to decline since March. Further declines are likely. As we have noted before, if the Dollar were to suffer a cataclysmic fall, then the financial markets would likely suffer. Yet, the U.S. economy remains stronger than most other developed economies, and, therefore, the Dollar is not likely to fall dramatically relative to foreign currencies. Foreign central banks continue to purchase Dollars, and no major country has any real incentive to allow the Dollar to collapse. In fact, other countries have complained that a weakened Dollar only impairs their ability to export goods to the U.S.

**The U.S. is not likely to repeat the mistakes that led to prolonged stagnation in Japan.** Many have compared the current economic conditions in the U.S. to those of Japan in the late 1980s, which ultimately led Japan into a prolonged period of deflation and 12 years of real growth averaging less than 1% per year. Both countries achieved great gains tied in large part to real estate markets that had been inflated with credit. They then suffered through similar fates – recessions that began with precipitous downturns in their



real estate markets. During these recessions, financial institutions began to fail, and both countries ultimately reacted by supporting those institutions and driving up public debt levels.

Yet, while the above similarities are undeniable, there are several critical differences between the U.S. and Japanese experiences. First, Japan – whose real estate bubble was actually much larger than the U.S. bubble – failed to adjust its monetary and fiscal policies until it was too late. In contrast, the U.S., having learned from the Japanese experience, has been the global *leader* in utilizing monetary and fiscal policy. In the last year alone, the U.S. has injected more stimulus than Japan did in 15 years.

Second, Japan failed to address the problems created within its banking sector in a timely manner. In contrast, the U.S. has been quicker to address the problems within this key sector of the U.S. economy.

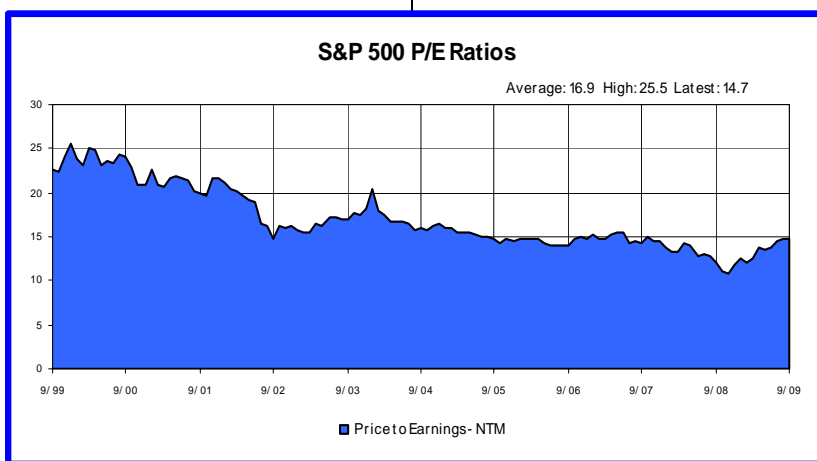
Lastly, Japanese companies generally failed to cut costs aggressively in the face of harsh economic conditions. In contrast, U.S. companies have cut costs dramatically and, as a result, have maintained reasonable levels of profitability. We note, however, that unless U.S. companies are able to resurrect some reasonable level of revenue growth in the future, it will become increasingly difficult to sustain high levels of profitability through cost cutting alone.

To be clear, Japanese-style stagnation does remain a potential threat to the U.S. economy, but the U.S. is actively working to avoid that scenario, and it currently appears unlikely to materialize. Nevertheless, we will monitor credit availability trends, consumer strength, corporate profitability, currency trends, and monetary and fiscal

policy to ensure that we can act accordingly in the unlikely event that the U.S. does follow the path taken by Japan 20 years ago.

**Equities as well as higher quality corporate and municipal bonds are likely to outperform risk-free assets, but investors should temper their expectations for high, steady returns over the next one to three years.** Even with the dramatic gains of the past two quarters, equity valuations remain reasonable by historical standards. In March, the forward price-to-

Investment-grade corporate bonds and higher quality municipal bonds are fairly priced after their gains during the past two quarters. With short-term Treasury rates still close to zero and 10-year Treasury yields of 3.3%, the environment for holding Treasuries and cash is not as favorable as it is for holding equities, investment-grade corporate debt, and higher quality municipal bonds. Of course, these conditions could change, particularly if, over the next few years, policy makers are unable to unwind their policies in an orderly fashion.



earnings ratio of the S&P 500 was about 10. It has now risen to about 15, which is still less than the average multiple for the last 10 years, about 17.

Corporate earnings must now improve in order to drive future gains. We continue to project average earnings growth of 5% or greater annually over the next five years, which should be sufficient to generate equity returns in excess of the returns offered by risk-free assets, provided that aggregate price-to-earnings ratios remain close to historic norms. We note, however, that while the equity markets are likely to advance over the next few years, that advance may be cyclical, depending on the frequency of disappointing reports.

## CONCLUSION

Expectations for a powerful “V-shaped recovery” are probably too optimistic, but expectations for prolonged, Japan-style stagnation are probably too pessimistic. Economic conditions have improved, and a recovery is likely underway, but the recovery, in all probability, will be muted. While equities, corporate bonds, and municipal bonds, as part of a diversified asset allocation strategy, should outperform risk-free assets over the next several years, investors should be prepared for a lengthy, choppy, and somewhat diluted recovery process and will need to maintain a longer-term perspective on the financial markets.

