Perspectives

January 20, 2010

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As we expected, massive governmental intervention on a global basis has led to increased stability in, and optimism surrounding, world economic conditions. With many forecasting a successful economic recovery and return to growth, the financial markets rallied for much of 2009, reversing some of their prior losses and rewarding persevering investors. We believe that there remains much to be optimistic about in 2010. Nevertheless, there is considerable uncertainty about the next few years, and we expect that, relative to past recovery periods, growth could be subdued, particularly in light of continued deleveraging, high unemployment, and softness in the U.S. real estate markets. As a result, investors should prepare themselves for the possibility of lower returns and continued market volatility in 2010.

REVIEW

At the beginning of 2009, the world was in a state of financial shock. The subprime crisis, the de facto suspension of lending activity, and the collapse of the U.S. housing sector had led to a massive, global recession and historic declines in the financial markets.

Yet, led by the U.S. and China, governments around the world collaborated to apply unprecedented policy stimulus, eventually leading to signs of economic stabilization in 2009. As investors gained conviction that the recession was at or near an end, the financial markets responded with vigor. By the end of the year, nearly universal despair had turned into global optimism, and patient investors were rewarded with unusually high annual returns.

U.S. Equities. The year 2009 started with the worst January and the second worst February in the history of the U.S. stock markets. The S&P 500 Index lost 8.6% in January and 11% in February. By March 9th, equity investors had been pushed to the brink of capitulation. The S&P 500 had fallen below 700 to hit a 13-year low, and the Dow Jones Industrial Average had fallen below 7,000 for the first time since 1997. With the Dow down 25.4% for the year and 53.8% from its record high close on October 9, 2007, many prognosticators feared the worst – an "Armageddon" scenario.

Fortunately, they were wrong. As fear gave way to a more rational recognition that world governments would not allow the financial markets to fall into ruin, the U.S. equity markets began a powerful rally that would last throughout the rest of the year. Fueled by unprecedented fiscal and monetary stimulus, the Dow rose 59.3% from its March low – its quickest rise since 1933 – and ultimately returned 22.7% for the year, making it the best year for the Dow since 2003.

The S&P 500 and NASDAQ Composite Indices fared even better. The S&P 500 returned 26.5% for the year, while the NASDAQ, after gaining nearly 80% from its March low, returned 43.9% for the year.

U.S. Fixed Income. As fixed-income investors increasingly became confident that the worst of the credit crisis had passed, corporate and municipal bond prices rose, while risk-free Treasury prices fell. Conversely, corporate and municipal bond yields fell, while Treasury yields rose. By the end of the year, "spreads" – the incremental yield offered by corporate bonds over Treasuries – fell from about 6.3% at the beginning of the year, when fear pervaded the markets, to just under 2.0%, reflecting a renewed appetite for risk.

For the year, the Barclays Capital Intermediate Government/Credit Index, which tracks a mix of government and corporate bonds, was up 5.2%; and the Barclays Capital 1-10 Year Municipal Blend Index, which includes municipal bonds from around the country, was up 7.2%. The Barclays Capital Intermediate Government Bond Index, which focuses on U.S. government and agency securities, was down 1.2%.

Real Assets. Commodities rebounded from the lows that they established early in 2009, but, even with their gains, many commodity prices remained significantly off their 2008 highs. By the end of the year, the Dow Jones UBS Commodity Index had risen approximately 19%, but it remained about 41% off its 2008 peak.

Optimism surrounding the economic recovery pushed oil prices dramatically higher in 2009. Having started the year at $44.60 per barrel, oil finished the year at $79.36 per barrel, a gain of approximately 78%. Nevertheless, it remained well below its 2008 high of approximately $145 per barrel.

Metals, too, were among the best performers in 2009. Gold closed the year at $1,095.20 per ounce for a gain of about 24%, attributable in large part to demand from investors seeking a hedge against inflation and a falling dollar.

Real estate, which in 2008 led the financial markets into a state of crisis, showed some signs of improvement in 2009. After falling precipitously since the beginning of the crisis, home prices generally stabilized and, in some cases, achieved modest periodic gains. It was unclear, however, whether this positive trend was part of a recovery in the housing sector or was attributable primarily to a combination of first-time homebuyer tax credits, favorable Federal Reserve policies that drove down mortgage rates, and other short-term governmental policies. Moreover, gains in the residential housing markets were overshadowed to some extent by increasing softness in the commercial real estate markets.

U.S. Dollar. The U.S. dollar had achieved significant gains throughout most of the recession, as investors increasingly looked to the world's reserve currency for some semblance of stability. Beginning in March, however, the dollar's upward trend was reversed, as investors moved into riskier assets such as equities and commodities. By the end of the year, the dollar's first-quarter gains had been erased, with the U.S. Dollar Index, which measures the dollar against a trade-weighted basket of currencies, finishing down about 4%.

International Markets. International investors, encouraged by low interest rates and signs of a global recovery, redeployed their risk capital and drove up foreign share prices. Many of the major international markets outperformed the U.S. markets, a phenomenon that was, in some respects, augmented by the falling dollar. The Dow Jones Global Index, excluding the U.S., was up 39.7% for the year in U.S. dollar terms.

The MSCI Emerging Market Index returned 78.5% for the year as investors became increasingly confident that the emerging economies would be among the best performers in the global recovery. Benchmark indices in Brazil, India, and China rose 82.7%, 81.0%, and 79.8%, respectively. Nevertheless, as the year ended, all three indices remained below their pre-crisis highs.

The MSCI EAFE (Europe, Australasia, and Far East) Index of developed economies returned 31.8% for the year. The United Kingdom's FTSE 100 had its best year in over a decade, rising over 22%, and Germany's DAX Index gained 23.8%. Japan's Nikkei Index was up 19%, held back in part by weakened exports, deflationary concerns, and political uncertainties.

ANALYSIS

In the October, 2008 issue of *Perspectives*, we remarked that Wall Street was in a state of sheer panic. We lamented that "investors increasingly have acted based on hysteria and not on rational observations of the markets and the fundamental economic environment for those markets" and that "some irresponsible reporters, politicians, and inexperienced investors have exacerbated the current panic by suggesting that, in fact, this crisis is some sort of new paradigm – something completely different in nature and magnitude than anything we have seen before."

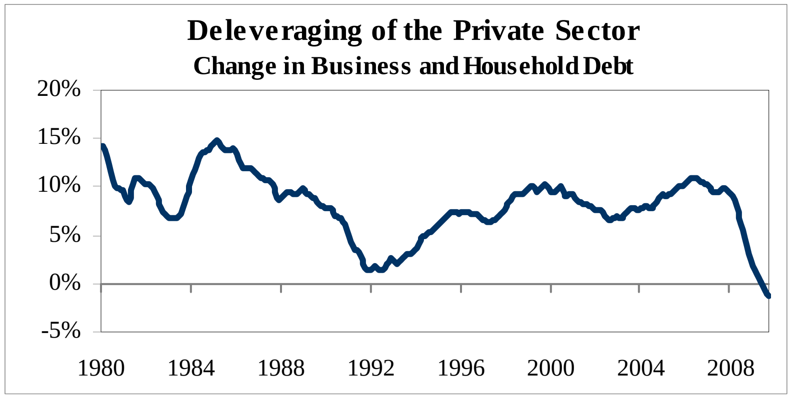
We argued that, while every financial crisis is unique, the current conditions were analogous to several other housing-related financial crises of the past, such as the Savings and Loan Crisis. After recounting how our financial markets and economy have endured myriad other financial crises throughout our history, we warned that "we recovered from every one of these crises, and, ultimately, those who lost the most in the context of these circumstances were the investors who panicked. Conversely, those who gained the most were the investors who refused to panic and who instead adhered to longer-term investment strategies and discipline."

We cited in our October issue acclaimed economist Stephen S. Roach – long known for his bearish views on the markets – for his comment that "the most important thing about financial panics is that they are all temporary. They either die of exhaustion or are overwhelmed by the heavy artillery of government policies." We asserted that while it was unclear when the current panic might end, it was clear that the governments, not only of the U.S. but also of the world's most powerful economies, would utilize their collective "heavy artillery" to end the panic.

From an historical perspective, we also reminded our readers that markets can move up as quickly as they can move down and that bear-market periods often are shorter than bull-market periods. We noted, for example, that during the bear market of January-May, 1970, the market fell 35.4% but that between May, 1970 and January, 1973, the market gained 124%.

With 2009 now behind us, our views have not changed. As has been the case repeatedly throughout our history, governmental policies have stabilized the world's financial markets, and yet another strong bear market has given way to a strong bull market. In its year-end review, published on January 4th, 2010, the *Wall Street Journal* led off with the statement that "financial markets staged a remarkable recovery in 2009, coming back from the brink of disaster thanks to unprecedented rescue efforts by governments around the globe." Indeed, while the official timing of the recession has not yet been announced, it does appear to have ended, with world economies transitioning into a period of recovery and growth.

Nevertheless, while some level of stability, and even growth, has been restored, there remains considerable uncertainty about the next few years. In our view, relative to past recoveries, growth in the U.S. and other developed nations could be subdued over the next few years, particularly in light of deleveraging by weakened financial institutions and consumers that have been allocating more capital toward paying down debt and less to spending. (See the following chart.) High unemployment and softness in the real estate markets are also impediments to rapid growth. Therefore, in 2010, investors should be prepared for the likelihood of more modest gains and continued market volatility.



We believe that the recession has ended and that we are now experiencing a recovery slowed by lingering economic weakness. While the recession appears to have ended sometime last year, and while the financial markets have rallied as investors concluded that a global depression had been avoided, significant problems remain unresolved, and the recovery is therefore likely to be restrained.

Importantly, the most immediate financial stresses have been alleviated. One year ago, there was little confidence in the financial systems of the world, credit was frozen, and many feared that a global depression was inevitable. A year later, governmental intervention has at least temporarily restored overall confidence in the major financial systems, credit is restrained but flowing, and fears of depression have largely abated. Thus, it appears that, for now, we have passed the point of maximum risk.

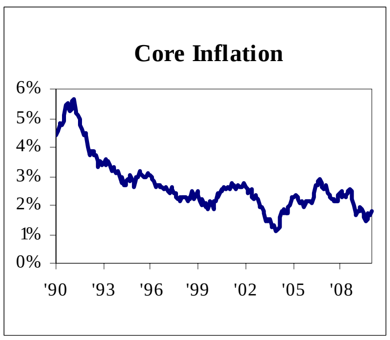
Yet, growth rates over the next few years are not likely to be as robust as in past recoveries. Consumers are still highly leveraged; unemployment rates remain high; credit is not flowing freely; the real estate markets are precarious; and governments are burdened by large budget deficits. Until these problems are resolved, the strength and longer-term sustainability of the recovery will be in question.

We expect fiscal and monetary policy to remain favorable during 2010, but investors should prepare for eventual policy reversal. With inflation seemingly under control (see below), the major central banks are unlikely to retreat from their policies of keeping interest rates low until there are further signs of economic strength. We believe that the Fed could start raising rates as early as this year or 2011 but that it will do so gradually and cautiously.

With regard to fiscal stimulus, most governments are unlikely to withdraw their stimulus programs until they are confident that their economic recoveries are self-sustaining. Japan recently announced new stimulus measures, and the U.S. also is considering additional stimulus. Nevertheless, there will be budgetary limits on governmental stimulus, particularly in smaller economies, and governments should be mindful that too much stimulus could be inflationary.

Inflation remains contained, and, in our view, should not be a threat for the next one to two years, but it could become a threat in the longer term. With interest rates at historic lows, it is not unreasonable to be concerned about the prospects of inflation. Yet, it must be noted that, even in light of the expansive monetary policies implemented by central banks to stimulate their economies, much of the money that normally would flow into those economies has remained trapped in banks that remain reluctant to make loans. It should also be observed that high unemployment rates, a weakened housing sector, and an oversupply of goods are impediments to inflation. In fact, while these trends are in place, the possibility of *deflation* remains real.

Core inflation rates have been falling, consistent with the historical pattern of such rates falling for about two years after a recession. Longer-term, however, inflation could become a problem, particularly if central banks are too late in tightening the supply of money or if fiscal policy is not properly controlled. Therefore, we will remain vigilant about inflation, especially in emerging economies like China, where we would expect it to appear before it hit the U.S.



We believe that the dollar's cyclical decline is not yet over but that, as long as the decline remains orderly, it should not hinder the recovery. A substantially weaker dollar over the longer term would make imports more expensive and, in turn, could lead to inflation. As we reported above, the dollar has fallen since March, and we believe that it will remain in a cyclical decline.

Yet, with the threat of inflation presently in check, the dollar's decline has, in all likelihood, contributed to the recovery of the U.S. economy. A lower dollar means that U.S. exports generally are more affordable to foreign buyers and more competitive in the global marketplace. Therefore, in our view, provided that the decline of the dollar remains gradual and orderly, it should bolster the economic recovery, reduce the trade deficit, and increase productivity.

We continue to favor selected risk assets over risk-free assets, but investors should be prepared for more modest returns and continued volatility over the next few years. While we are forecasting only moderate economic growth over the next few years, we note that a slower growth environment is not necessarily a bad thing for stocks. Such an environment could serve to keep inflation contained, interest rates low, and fiscal stimulus in place for an extended period of time. As investors were reminded in 2009, low inflation, low interest rates, and fiscal stimulus programs can be quite favorable for stocks. Large amounts of sidelined cash, currently earning almost nothing, could also support higher stock prices as investors are pressured to seek greater returns for their capital.

Effective stock selection will be critical in an increasingly competitive and complex landscape. We continue to favor larger companies with significant international exposure and which, in our judgment, are likely to benefit from faster growth rates abroad and a declining dollar. The industrial sector, in particular, could thrive in a global economy driven by exports and capital spending. Mid-cap companies may also offer some opportunity, as increased merger and acquisition activity could drive prices higher.

Volatility, though, could continue in 2010, and stocks may experience periods of consolidation over the year. Equity investors therefore will need to maintain a longer-term perspective on returns.

Corporate bonds, too, remain worthy of consideration, particularly for investors who are looking to invest their cash but are unwilling to assume the risks associated with investing in stocks. Relatively attractive yields (compared with yields on government bonds), favorable Fed policy, stronger corporate balance sheets, and a gradually improving economy all are supportive of corporate bonds.

Internationally, we remain positive about select developed and emerging markets. Tactically, however, investors again should be prepared for the possibility of one or more consolidation phases.

We also believe that the bull market in commodities has not yet ended. Continuing demand from emerging markets such as China, together with a lower dollar and low interest rates, argue for strength in a wide range of commodities. Gold still has upside potential, but we expect its rise to moderate.

CONCLUSION

While the recession is likely over, significant problems remain unresolved, and the recovery is therefore likely to be restrained. We believe that in 2010, unless there is a substantial change in circumstances, governmental policy should remain accommodative, inflation should remain contained, and the dollar's decline should be orderly. Given these conditions, we favor carefully selected equities, corporate bonds, and other risk assets as part of a longer-term, diversified portfolio strategy, but investors should be prepared for lower returns and continued market volatility in 2010. We remain alert for any changes in the current conditions, which might necessitate a tactical response.

Market data provided by BCA Research, FactSet and the *Wall Street Journal.*