

What's Ahead in 2010

An Investment Perspective

Mid-Year 2010 Update

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The Economic and Market Backdrop

A Double-Dip Recession Remains Unlikely

At the beginning of 2010, we expected to see a modest cyclical recovery that was countered by the structural problems facing most of the developed world. For the first four months of the year, the cyclical recovery did dominate, but over the past two months, structural problems (especially those in Europe) began to win out, and risk assets have been struggling.

While we have long expected that the US and global economic recovery would be subpar, fears of a double-dip recession have intensified in recent months. In our view, it would be unlikely for the economy to move back into recession. As has been the case since the recovery began in the middle of last year, consumer spending and employment trends remain key to keeping it on track. The corporate sector has remained resilient and business spending levels have been increasing, but this part of the economy by itself will not be able to drive economic growth. Income levels have been rising, and while consumer spending has been struggling, it has remained relatively firm. On the employment front, the pace of improvement has been painfully slow, but the monthly jobs picture has turned positive. Unemployment remains high, but corporate spending trends suggest that businesses are increasingly becoming more expansion-oriented, which hopefully will translate into accelerated hiring.

Overall, we expect to see slightly slower economic growth in the United States over the next several quarters as financial and monetary stimulus is gradually removed. Outside the United States, the risks of a renewed recession are higher, especially in Europe. Domestically, however, we would remind investors that true double-dip recessions are quite rare, and unless there is a major shock to the economy, we believe the recovery will continue.

Deficits, Inflation and Interest Rates

Governments, policymakers and investors around the globe have become more concerned about the massive size of fiscal deficits in the world's developed economies. The global recession, the massive amount of stimulus measures enacted over the past couple of years and long-term increases in spending have inflated fiscal deficits to astounding proportions. With the exception of Europe, however, few countries have made any serious efforts to reign in spending or to tighten policy.

Over the long term, the combination of high deficits and low interest rates is a recipe for inflationary pressures, which would be a negative for risk assets. Nevertheless, most central bankers around the world recognize that it would be counterproductive to increase interest rates at this time. In the immediate term, we continue to believe deflation is a more serious concern than inflation. In the United States, inflation is trending lower, with core inflation at its lowest

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- ▶ Given the renewed credit issues in Europe and the slack in the labor market, we do not expect to see higher interest rates in the near future.
- ▶ Global equity markets saw negative quarterly returns—and for many markets, this quarter delivered the first downturn since the bull market began in March 2009.
- ▶ One of the worst-performing markets was China. Despite continued strong economic growth in that country, investors have grown increasingly uneasy over the implications of the rising strength of the yuan as well as the government's attempts to regulate growth.

rate in almost 40 years. Europe is in the midst of a deflationary credit crisis and Japan has been mired in structural deflation for quite some time. Observers are right to question the long-term sustainability of running high deficits, and ultimately, policymakers will need to reverse course. However, given the renewed credit issues in Europe and the slack in the labor market, we do not expect to see higher interest rates in the near future.

The Second Quarter by the Numbers

Financial markets took a dramatic turn in late April, as investor sentiment became dominated by concerns over the European sovereign debt crisis, some less-positive economic data and uncertainty over financial regulatory reform in the United States. Volatility levels moved noticeably higher over the past several months, and investors embarked on a renewed “flight to quality,” abandoning risk assets such as stocks in favor of safer alternatives, most notably Treasury bonds and gold. Not surprisingly in this environment, global equity markets saw negative quarterly returns—and for many markets, this quarter delivered the first downturn since the bull market began in March 2009. In the United States, the Dow Jones Industrial Average fell 9.4% to 9,774 and is down 5.0% for the year. The S&P 500 Index fell 11.4% to 1,030 and is off 6.7% for the year. The Nasdaq Composite also posted a sharp quarterly loss, falling 12.0% to 2,109, and is down 7.1% for the year.

Market performance outside of the United States followed a similar pattern, with most markets experiencing even sharper declines. In Europe, credit issues sparked dramatic investor risk aversion, leading European equity markets to significant declines. For the quarter, the MSCI Europe Index declined 15.2% and is down 16.7% for the year. UK stocks lost 13.4% on a quarterly basis and are off 9.2% for the year. German markets, supported by strong exports, performed relatively better, declining a modest 3.1% for the quarter, bringing the year-to-date return to 0.1%. Equity markets in Japan (which continues to face deflationary problems) also performed poorly during the quarter, with stocks down 15.4%. One of the worst-performing markets was China, which suffered a quarterly loss of 22.8%. Despite continued strong economic growth in that country, investors have grown increasingly uneasy over the implications of the rising strength of the yuan as well as the government's attempts to regulate growth.

In bond markets, yields fell sharply (and prices rose) during the quarter amid the heightened uncertainty. The yield on the 10-year Treasury declined from 3.84% at the beginning of the quarter to 2.96% by June 30. In all, the Barclays Capital US Aggregate Bond Index gained 3.5% for the quarter and is up 5.3% for the year. Finally, cash investments, as represented by the 3-month Treasury bill, returned only a minor fraction over 0% for the quarter, as short-term rates remain very low.

The Outlook

Our cautiously optimistic outlook for equity markets is predicated on our belief that the economic recovery should be sustained. As indicated earlier, the recovery is certainly fragile, but should be able to transition into an outright expansion later this year. Monetary and fiscal policy remains stimulative, and significant and/or rapid tightening does not appear to be in the cards.

In addition to the relatively positive macroeconomic backdrop, equity market fundamentals remain sound. Companies have successfully managed their costs during the recession and have since been increasing their revenues. As a result, we expect that both profits and earnings will continue to improve, especially if economic growth is able to remain on track. The combination of lower equity market prices and still-improving earnings has resulted in attractive valuations for stocks.

As the recent downturn illustrates, equities remain subject to a number of downside risks, but, in our view, still appear more attractive than potential alternatives. As has been the case for some time, cash investments are returning essentially nothing, and Treasury yields of around 3% are not enticing. The combination of a fragile economy, subdued economic growth and low inflation suggests that equity returns will be only modest in the years ahead, but low interest rates mean that other asset classes will also be challenged.

We continue to foresee higher equity prices in the second half of the year. Although the reasonably positive fundamental backdrop has not significantly changed over the past couple of months, volatility levels have increased as investors have become more focused on external risks and shocks. The lack of clarity around the future direction of the global economy has unnerved investors, but, in our view, the market downturn that has occurred over the past two months is best categorized as a correction and not as the start of a new bear market. Nevertheless, high volatility is likely to prevail until there is more clarity around the path of economic growth and until the sovereign debt crisis is more clearly resolved.

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The Scorecard So Far

At the midway point of the year, the broad economic themes we forecasted have so far played out more-or-less as we expected. The global economy is slowly improving, with the United States and emerging markets leading the way; corporate earnings are still strong; and inflation remains a non-threat. Our financial market forecasts, however, are looking a bit shakier. We still expect to see full-year gains for equity markets, but acknowledge that the downside risks are substantial.

1. The US economy grows above 3% in 2010 and outpaces the G-7.

Unless the economy slows more significantly than we expect in the second half of the year, this prediction appears on track. There are lingering areas of economic weakness (notably the housing market), but on balance the US economy continues to grow. The second half of this prediction seems almost a certainty at this point. The cyclical recovery in the United States is significantly stronger than it is in other developed markets, a trend that we expect will continue.

2. Job growth in the United States turns positive early in 2010, but the unemployment rate remains stubbornly high.

Employment trends turned positive early this year, and while the pace has been slow, we expect to see an acceleration in jobs growth as the year progresses. One disappointing aspect of jobs growth has been that a significant percentage of it has been associated with temporary census hiring by the government. Still, we believe private-sector hiring should pick up as businesses continue to recover. Unemployment levels are likely to remain high, however, since more and more people continue to enter the workforce. More specifically, we do not expect to see unemployment fall below 9% in 2010.

3. Earnings rise significantly despite mediocre economic growth.

This scenario has indeed been playing out as we expected. While the broader economy has been experiencing a sort of mediocre “U-shaped” recovery, profits have experienced a more dramatic “V-shaped” rebound, which has been driving corporate earnings higher. Consensus expectations are for continued strong earnings growth for the rest of this year.

4. Inflation remains a non-issue in the developed world.

As discussed earlier, deflation in the developed world remains a more significant threat than inflation, a scenario that is unlikely to change any time soon. Inflation pressures are a longer-term concern, but as of now, inflation levels are steady or falling throughout the developed world.

5. Interest rates rise at all points on the Treasury curve, including fed funds.

This is one prediction that we will probably get wrong this year. Risk aversion and credit issues have kept interest rates low throughout 2010, and Treasury yields have fallen significantly in the first half of the year. Before the emergence of the European sovereign debt crisis, we had expected the Federal Reserve to signal that it was getting close to increasing rates, but at this point, we have no near-term expectation that the Fed will act.

6. US stocks outperform cash and Treasuries, and most developed markets.	Equity markets made solid gains in the first four months of the year, but ongoing structural problems caused stocks to give up those gains. At the midpoint of this year, US stocks are underperforming cash and Treasuries, although they are outperforming most other developed market equities. While we still expect this prediction to come true, we acknowledge that it will require a renewed rally in equity markets later this year.
7. Emerging markets outperform as emerging economies grow significantly faster than developed regions.	We are on the fence at this point as to whether this prediction will come to fruition. Emerging market economies have continued to grow more quickly than their developed counterparts, but equity market performance has been uneven. Emerging markets struggled to keep pace with developed markets earlier this year, and, in many cases, the disparity worsened during the correction. In any case, we maintain a favorable long-term view toward emerging markets.
8. Healthcare, information technology and telecommunications outperform financials, utilities and materials.	On a year-to-date basis, all sectors are in negative territory. Consumer-related sectors have been holding up relatively well, while energy, information technology and materials have been the hardest hit. Regarding the sectors we specifically discussed in our prediction, we are slightly on the wrong side of this one, as a basket of our “least favored” sectors has modestly outperformed our more favored group. We will need to see some improvement in our favored sectors for this prediction to come true.
9. Strong free cash flow and slow growth lead to an increase in M&A activity.	Businesses have been highly focused on their balance sheets during the economic downturn and have managed to maintain high levels of cash. This factor, combined with businesses’ difficulty growing organically in a slow-growth economy, has pushed companies to ramp up merger and acquisition activity. Dividend increases and share buybacks have also remained noticeable trends, and we expect all of these equity-friendly activities to continue later this year.
10. Republicans make noticeable gains in the House and Senate, but Democrats remain firmly in control of Congress.	Political fortunes change rapidly, and at this point, some pundits are forecasting that the Republicans may, in fact, take control of the House of Representatives in the fall. For now, we’ll hold with our forecast that the race will be close, but that the Democrats will retain control of Congress.

What's an Investor to Do?

The past couple of months have been difficult for investors, but we are holding to our view that the recovery will continue and stocks will gain ground. As always, we encourage investors to work with their financial professionals to focus on their long-term objectives and to find tactical investment strategies that work within the context of their long-term plans.

Stick With Stocks: Over both the long and short term, we think stocks are better positioned than cash or Treasuries and that investors should retain overweights to equities. Global equity markets are likely to experience continued high volatility and returns may be uneven, but stocks should grind higher in the coming months and years.

Rotate to US Markets: The United States still faces some long-term structural problems, but compared to other developed markets, US economic growth should be stronger and US stocks appear poised to outperform. This is not to say that international equities should be avoided, since they continue to represent a valuable diversification tool, but simply that we see greater opportunities in US markets.

Stay With Emerging Markets: The long-term case for investments in emerging markets remains intact. As a particular area of opportunity, we suggest an emphasis on US multinational companies, which can benefit from growth trends in emerging markets.

Focus on Quality: We have been saying for some time, but our view still holds, that in an environment of slow-but-positive economic growth higher-quality investments continue to look attractive.

Selectivity Still Key: As we said in the beginning of the year, 2010 is likely to be marked by ongoing volatility and heightened dispersion among winning and losing investments. In this sort of environment, selectivity will be critical.

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