Lazard Insights

Conference Call Series

17 August 2009

Summary

Buy or Beware? Investing at the Crossroads

Featured Speaker: Ronald Temple, CFA, Managing Director, Portfolio Manager/Analyst

Latest Views on the Housing Market

We decided to begin this discussion with housing because we believe there is a good chance that near-term events could be misinterpreted. Specifically, we have seen many trumpet the increase in house prices in the last part of May 2009 as the end of the decline in house prices. As illustrated in Exhibit 1, we believe that house prices still have room to fall.

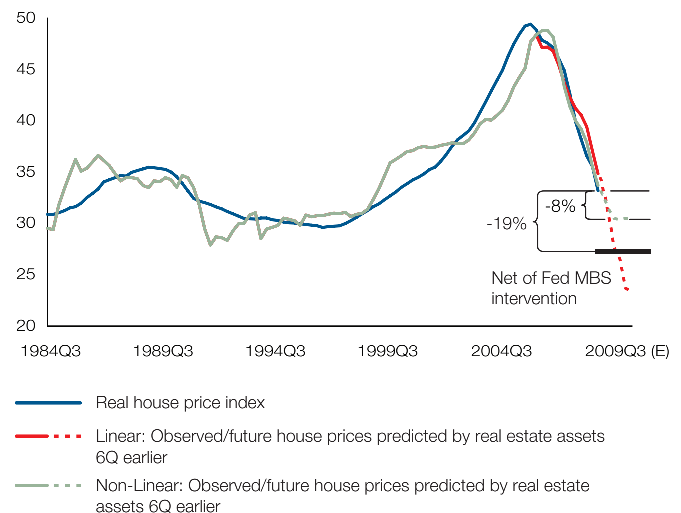
In our most recent report, we included two different scenarios based on two different models—linear and non-linear—that we believe better capture the range of potential outcomes than did our previously published approach.

The bull case, or a decrease of 8% from May 2009 levels, could be considered a scenario reflective of successful government intervention. Specifically, it would reflect a situation in which mortgage debt outstanding decreases far less than would be expected under the linear model, leading to a lower house price downside.

The bear case, or a decrease of 19% from May 2009 levels, reflects a situation in which the government only temporarily succeeds in reducing the downside in house prices. The 19% decrease takes into account interest rate reductions that resulted from direct government intervention in the mortgage-backed security (MBS) markets.

In both scenarios, we still expect a downside. However, one bullish factor is that we actually expect house prices to increase for the next two-to-three months, as the direct government intervention in the MBS markets and efforts to reduce the supply of foreclosed homes continue to benefit prices. We believe this upside should occur in either scenario. The positive potential of this two-to-three month upturn is that people may begin to believe that they have missed the opportunity to buy a home

Exhibit 1: Real House Price Index versus House Price Predicted by Real Estate Assets and Mortgage Liabilities



As of March 31, 2009

Source: Board of Governors of the U.S. Federal Reserve System, Flow of Funds Accounts of the United States, Section B.100 Balance Sheet of Households and Nonprofit Organizations, OFHEO, Standard & Poor's/Case-Shiller Home Price Indices, Bureau of Labor Statistics, Bloomberg[1]

Seasonal adjustments were made using a linear moving average.

Predicted changes in mortgage debt based on a single-factor linear regression model and a single-factor non-linear regression model. Both models were developed by Dr. Emma Rasiel, Assistant Professor of the Practice of Economics, Duke University. For more information, refer to the Lazard Investment Research paper "The Crumbling Foundation of U.S. House Prices: August 2009 Update," available at http://www.lazardnet.com/lam/us/literature_research.shtml.

There is no guarantee that the stated forecast will be realized.

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before prices and mortgage rates increase, further propelling demand, and potentially changing our model for the positive.

Given these factors, we believe that the most likely (or base case) scenario is for 10% to 15% downside from the levels at the end of May 2009. In any case, we do not believe that the recovery will be led by the U.S. consumer, as even if the bull case is realized, the average American with a mortgage will likely have close to zero equity in his or her home. This would mean that 20 to 25 million U.S. homeowners would be underwater—no recipe for a consumer spending boom.

Takeaways from Earnings Season

We chose two quotes from CEOs within the same industry to highlight the differences in perspective regarding the current economic situation.

A.G. Lafley (CEO, Procter & Gamble):
"Our planning basis is the same market growth rates that we saw in the last quarter, which was essentially flat. So we really haven't—we're really not going to be in the business of calling the bottom, so to speak....

What I will tell you, though, is that the rates of decline have clearly decelerated. So, it's not as bad sequentially as we've seen in the past, and it appears to have flattened out quite a bit."

Paul Polman (CEO, Unilever PLC):
"Although many keep quoting the increased amount of green shoots that are coming up, we'd just like to continue to be realistic, hopefully proven wrong, but I'd like to plan the business accordingly.

This is, without any doubt, the longest and deepest recession we've seen during the post-world-war period. And, whilst it might have bottomed out, we do not believe that there are any signs of a fast recovery. In fact, we expect that many parts of the world, such as Western Europe, Eastern Europe, will still soften before they bottom out."

While these statements are not entirely contradictory, they do reflect what we are seeing across a wide range of companies and industries: Deterioration in demand seems to have decelerated, if not ceased altogether, and there are few signs of an imminent upturn.

We feel it is important to differentiate indicators from earnings reports to help determine the state of the economy, including:

- **Demand factors: Restocking or sales, domestic or international**
  Some of the more positive indicators include industrial, automotive, and technology companies, which suggest that the inventory depletion or destocking trend has run its course. For example, in the industrial space, U.S. Steel has begun to hire back a number of employees as capacity utilization began to recover from as low as 38% in some businesses. Another good example is the automakers, as auto production in the United States had declined to levels as low as five million units per year versus end-demand of 10 to 12 million units. Due to this disparity, we believe we could see an increase in production of as much as 35% to match demand.
- **Data points: Leading, lagging, or coincident**
  A less expected coincident or leading indicator is data from distributors of computer products and semiconductors to original equipment manufacturers, such as Avnet and Arrow Electronics. These companies provide a good read on demand for electronic components without much distortion from changes in inventory. As cancellation rates for both companies have begun to decrease, the outlook for purchase requirements has increased, the book-to-bill ratio is now positive, and both companies believe inventory reductions are now largely over.
  Also in the information technology sector, Ingram Micro, the largest distributor of personal computers, printers, software, storage, and networking products to small-to-medium sized businesses, provides a nice read on end-demand technology spending due to their broad range of products and customers. Ingram indicated that demand is no longer deteriorating, pointing to a geographic split as trends in Asia improve, North America stabilizes, and Europe is still unstable.
  More negative indicators include trash companies and restaurants. For example, some of the revenues for trash hauling company Republic Services are related to the construction industry. This is a lagging indicator, or coincident at best as it reflects decisions made some time ago to build. That said, trash volumes carried by Republic were down just below 11% during the second quarter of 2009 (compared to the second quarter of 2008), versus 8% in the first quarter of 2009 (compared to the first quarter of 2008), which indicates an accelerating downside. Though this indicator is negative, it is also coincident at best, hence might be replaced by what people intend to buy.
  Restaurants are also showing deterioration in sequential, monthly same-store comparisons. However, this could merely reflect a higher savings rate, leading to more consumer purchases of groceries rather than eating out as consumers trade down.
- **Earnings drivers: Cost reduction or revenue growth**
  The early story of the second quarter earnings was all about cost cutting, but, as illustrated in Exhibit 2, revenues came out approximately 30 basis points higher than consensus expectations (when considering data through August 7, 2009). We believe that much of this may have been driven by higher energy and commodity prices.
  Expenses came in approximately 80 basis points below the expected level. We believe that the cost-cutting element can only be sustained for so long, which underlines the importance of observing leading indicators.

Exhibit 2: S&P 500 Index Income Statement (ex-Financials) through August 7, 2009

S&P 500 Index Income Statement (ex-Financials)								
Particulars	2Q09 Actual	2Q09E Expected	Diff	% Diff	1Q09	Q/Q%	2Q08	Y/Y %
Revenues	1,409.7	1,406.2	3.5	0.3%	1,359.7	3.7%	1,744.5	-19.2%
Operating Costs	1,218.6	1,228.7	-10.1	-0.8%	1,205.2	1.1%	1,489.9	-18.2%
EBIT / Operating Income	191.1	177.5	13.6	7.7%	154.5	23.7%	254.6	-24.9%
EBITDA	277.2	259.6	17.6	6.8%	243.9	13.7%	344.0	-19.4%
Pre-Tax Income	148.8	156.1	-7.4	-4.7%	106.1	40.2%	205.3	-27.5%
Net Oper. Inome (Earnings)	102.5	97.6	4.9	5.0%	77.9	31.5%	142.9	-28.3%
Margins								
EBIT	13.6%	12.6%	90 bp		11.4%	220 bp	14.6%	-100 bp
EBITDA	19.7%	18.5%	120 bp		17.9%	170 bp	19.7%	-10 bp
Pre-Tax	10.6%	11.1%	-50 bp		7.8%	270 bp	11.8%	-120 bp
Net Operating	7.3%	6.9%	30 bp		5.7%	150 bp	8.2%	-90 bp

Source: Morgan Stanley Research, Thomson Financial, Compustat

Credit market update

The credit markets have become an increasingly important source of information for many equity market investors, and have been surprising in the pace and degree of healing thus far. For example, in January 2009 only the best borrowers could obtain credit. However, by June it seemed as though pretty much anyone could borrow again (although it was expensive). Borrowing rates across the board have declined, explained by the data in Exhibit 3.

During the first half of 2009, the U.S. Federal Reserve (the Fed) and Treasury had purchased over $900 billion of MBS and Agency debt. These purchases totaled roughly 35% of all credit instruments issued in the United States (excluding Treasurys) in the first half of the year or, put another way, 85% of all securitized paper issued in the first six months of 2009. This left debt investors in a tough position: Risk-free was a poor choice, as the 10-Year Treasury rate closed 2008 slightly above 2%, and mortgages were unattractive, as investors had front-run the Fed and pushed yields (in terms of Fannie Mae 30-year fixed rate MBS) to historic lows. Investors bought high-grade corporate debt and, as yields fell in that space as well, moved toward high-yield debt to obtain the yield they required. This appears to be what the Fed wanted—by driving investors to allow companies to term out their debt, the Fed averted widespread corporate defaults.

Exhibit 3: The U.S. Federal Reserve's Influence on Credit Markets

Program Name	Potential Size	Outstanding
GSE MBS Purchases (Federal Reserve)	$ 1,250	$ 742
GSE MBS Purchases (Treasury Department)	No limit	$ 172
GSE Debt Purchases (Federal Reserve)	$ 200	$ 111
Subtotal - GSE and MBS Intervention	$ 1,450	$ 1,025
Commercial Paper Funding Facility	$ 1,300	$ 58
TALF	$ 1,000	$ 41
PPIP	$ 1,000	$ -
TARP	$ 700	$ 457
Designated but not yet deployed		$ 184
Subtotal - TARP	$ 700	$ 641
U.S. Treasury Purchases (Federal Reserve)	$ 300	$ 220
Subtotal - Cash Intervention	$ 5,750	$ 1,986
TLGP-Debt Issuance	$ 789	$ 339
TLGP-Transaction Account Guarantees	$ 700	$ 700
FHA Loan Guarantees	$ 300	$ -
Subtotal - Non-cash Guarantees	$ 1,789	$ 1,039
Total	$ 7,539	$ 3,025

As of August 14, 2009

Source: U.S. Treasury Department, Federal Reserve, Federal Housing Finance Administration, Federal Deposit Insurance Corporation, Federal Home Loan Administration, Fannie Mae, Freddie Mac, Bloomberg

Investment Implications:

Questions We Have

- **How much of investor expectations are already priced in?**
  Based on the information discussed thus far, we question whether short-term risk is actually to the upside for the markets. Money market balances remain near record levels while many investors await a pullback to put their money to work. Moreover, we believe that the near-term information flow from housing, inventory depletion, and the credit spread compression is likely to be more positive than expected.
- **How much insight can we derive from credit markets relative to equity markets?**
  It is important to be aware that credit markets are prone to overshoot, as they did when spreads reached historically tight levels in 2006 then exploded during the credit crisis. This is a typical pattern in part because there is more leverage under the credit markets relative to equities, and in part because direct government intervention in the credit markets is unprecedented in form and degree.

Answers We Know

- **Anchoring of expectations can be dangerous**
  Many investors and investment professionals talk about missing the bottom on March 6th. The real question is: March 6th of what year? On March 6, 2009, the S&P 500 Index was at 666, while on March 6, 2008 the Index was at 1,304. If an investor chooses a single point of reference for market levels, they can create a risk of making bad investment decisions based on the wrong anchor.
- **Backward-looking strategies are no longer relevant**
  In our view, basing decisions on valuations and models that rely on history going back to the 1980s and 1990s is a poor approach. The era of disinflation is over, and looking to that single era as the only source of guidance is suboptimal at best. We believe that there will be periods when people rush to risky assets with weak balance sheets and low or no cash flow, but our advice is to be very leery of such rallies.
- **Forward-looking analysis is a necessity**
  The recovery will not be led by the consumer, and it will not be led by leverage, as in past recessions. This is evidenced by the most recent Senior Loan Officer Opinion Survey, which indicated that the banks still are not easing their lending standards. Differentiation has only just begun in the markets, and we expect that there will be winners, survivors, and losers, and the real task is figuring out how much these companies might be worth in a range of scenarios.

IMPORTANT INFORMATION

Published on 31 August 2009.

1. Aggregated U.S. house price data were obtained from two sources, the Office of Federal Housing Enterprise Oversight (OFHEO) (http://www.ofheo.gov/hpi.aspx), and the Case-Shiller Home Price Index (available from Robert Shiller's website: http://www.econ.yale.edu/~shiller/).

The OFHEO data begins in the first quarter of 1975, while the Case-Shiller Index begins in 1987. We chose to merge the two series, because the Case-Shiller Index provides what we view to be a more accurate assessment of U.S. house prices in recent years. We used a simple regression model to "backdate" the Case-Shiller Index from its starting point in 1987 back to the OFHEO data starting point in 1975.

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