

# Lazard Insights

Conference Call Series

20 April 2010

## Summary

### Checking the Pulse of the Economy

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

There are still meaningful crosscurrents affecting the economy. In the near term, we believe there are many positive economic drivers that could surprise investors to the upside. Beyond 2010, however, we believe there will be a number of significant challenges.

#### The U.S. Federal Reserve's Balance Sheet Has Evolved

Exhibit 1 illustrates the U.S. Federal Reserve's (the Fed's) balance sheet and the different assets the Fed owns (excluding certain items, such as currency in circulation, gold reserves, and other undefined assets which aggregate to about \$200 billion throughout the time period covered by the chart). This chart shows several important points:

- **The Fed's balance sheet has more than doubled in size versus two years ago.** Despite this, the inflation implications are not the ones that people may suspect. Traditionally, when the Fed wanted to increase money supply, it would credit the reserve accounts of member banks. Those banks, in turn, would use those reserves to lend money with an approximate leverage factor of 10 to 15 times. In the current crisis, the Fed opted to credit member accounts and then use those reserves to buy assets directly (i.e., simply creating money and buying assets with no incremental leverage). If typical leverage were applied, the growth in the Fed's balance sheet would be approximately 10% versus the much higher growth that occurred over the past two years.

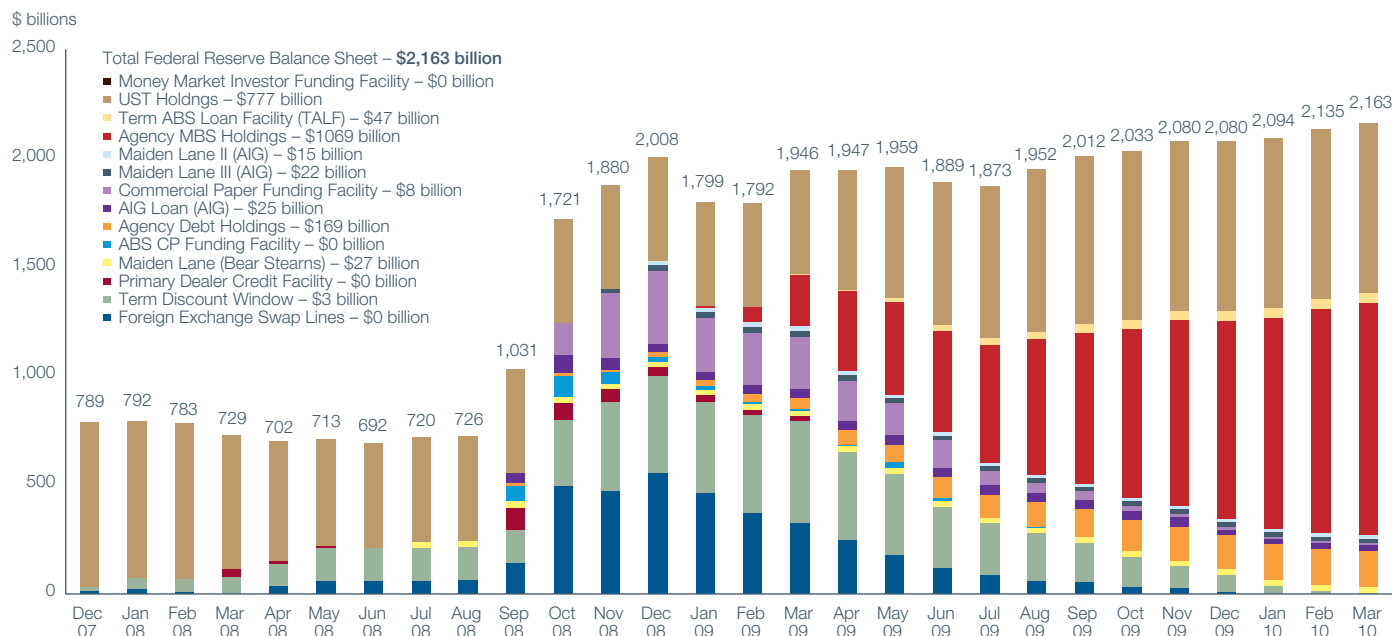
- **The composition of the balance sheet has evolved rapidly.** The one constant in Exhibit 1 (in tan) is the Fed's holdings in Treasuries, which has historically been around \$750 to \$800 billion. Other than Treasuries, the rapidly evolving balance sheet reflects the needs of the financial markets. For example, in November and December of 2008 the largest items were "Foreign Exchange Swaps," "Discount Window," and "Commercial Paper Funding Facility." As the markets re-opened for these assets, the amounts allocated to them shrank on the balance sheet, as the Fed was charging rather punitive rates for the borrowing.
- **The two largest portions of the balance sheet are currently mortgage-backed securities (MBS) and Treasuries.** The MBS portion will likely take a while to divest. For example, by the end of 2011, we believe over \$200 billion of the current \$1.25 trillion will either mature or be pre-paid by borrowers.

The Fed has already exited quite a few programs that it began as a response to the crisis. There are still several programs that are ongoing and will be on the Fed's balance sheet for a while, but new activity is decreasing. Thus far, the markets have not been disrupted by the Fed's initial exit.

#### House Prices: The Market-driven Model

Our original model on home prices was disrupted by the government intervention. As we had initially stipulated, the model we released in early 2009 was based on historical data—a period of time when house prices always went up.

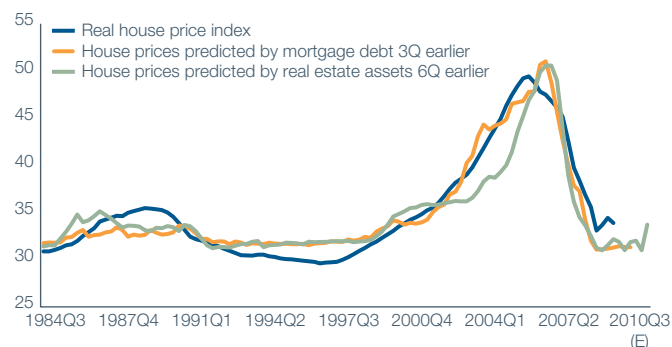
## Exhibit 1 The U.S. Federal Reserve's Balance Sheet



As of 31 March 2010

Source: U.S. Federal Reserve

## Exhibit 2 Market-driven House Price Model



As of 31 December 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<sup>1</sup>

Seasonal adjustments were made using a linear moving average.

Predicted changes in mortgage debt and real house prices based on single-factor quadratic regression models. Both models were developed by Dr. Emma Rasiel, Associate 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: May 2010 Update," available at [http://www.lazardnet.com/lam/us/literature\\_research.shtml](http://www.lazardnet.com/lam/us/literature_research.shtml).

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

Therefore, we were concerned that the historical relationships we observed might not work when home prices were falling. Additionally, the degree and breadth of government intervention was unprecedented, which disrupted the relationships we had found between the changes in the total value of all U.S. residential real estate, the changes in aggregate mortgage borrowing, and the levels of home prices. We recently updated our model, as shown in Exhibit 2, as the government initiated its exit from the sector. Based on the updated model, we believe that house prices are either at or very close to reaching a bottom. This view is currently less pessimistic than the view of many market participants, who generally expect another 5% to 10% downside move in home prices.

Despite our optimism that the prices of homes in the United States are near a trough, we also believe that there are approximately 4.5 million homes that will be foreclosed over the next three years. While this is more optimistic than our previous forecast of 6 million homes (reduced due to homes that have been foreclosed since the original estimate and the positive effect of government intervention in the sector), it still represents a significant overhang of housing inventory that could take as long as three to four years to absorb, at the current rate.

Mortgage modification programs have also helped to reduce downward pressure on prices from sales of foreclosed homes. Each year there is a natural demand for homes. The longer a foreclosure is delayed, the more time the natural demand in the market has to catch up with the oversupply of homes. Additionally, the pressures on home prices are spread out over a longer period of time rather than all in a given year or shorter time period. By reducing the downward pressure on home prices, the number of strategic defaults and related foreclosures have decreased.

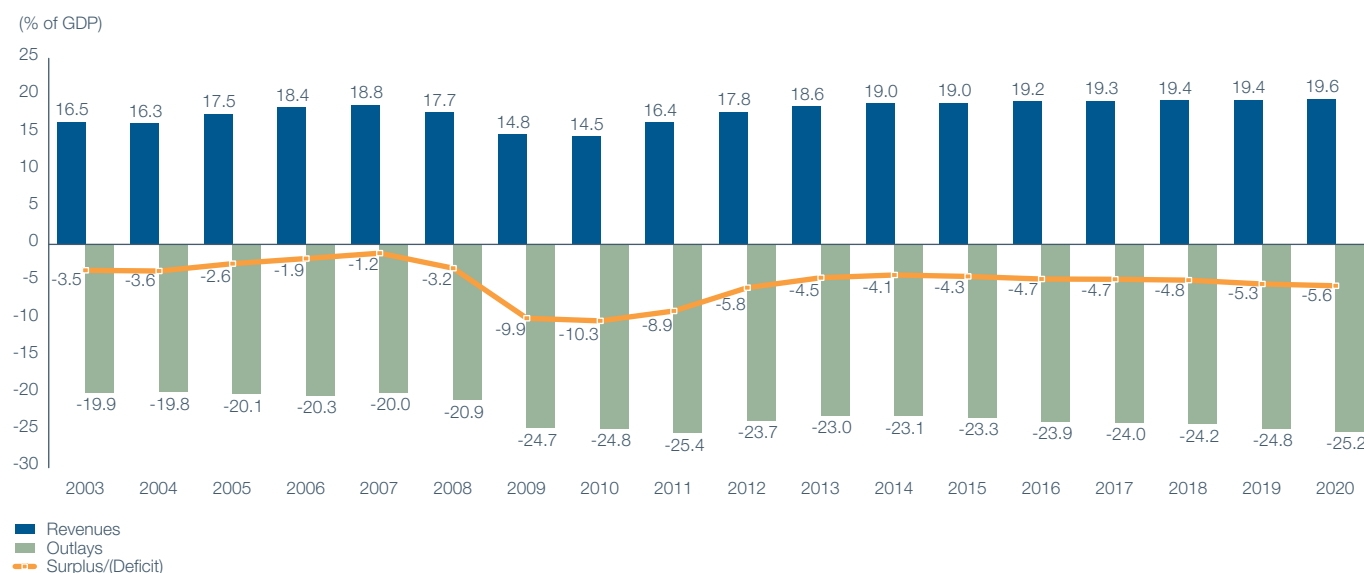
### Crosscurrents within Fiscal Stimulus

The original fiscal stimulus plan from the U.S. Government was to cost \$787 billion. The estimated cost has now risen to \$862 billion. The three main drivers of the increase include: approximately \$34 billion for supplemental nutritional assistance programs, \$26 billion of Build America Bonds, and \$21 billion in unemployment benefits. Thus far, only \$314 billion of the original \$787 billion has been deployed through tax cuts, spending, and transfers to state and local governments. As a result, we believe that it is too early to call whether or not fiscal stimulus has worked.

The plan, as assessed by the Congressional Budget Office, was for the bulk of the stimulus to benefit fiscal year 2010 (the Federal fiscal year ends on September 30). About \$185 billion of the stimulus was used in fiscal 2009. There is almost \$400 billion slated to be used in fiscal 2010, which we estimate will add an incremental 1.5% tailwind to GDP for the year relative to 2009. However, only \$135 billion in stimulus is currently allocated for 2011. This lower number becomes a significant headwind for GDP—a reduction of approximately 1.86%. We continue to see headwinds beyond 2011 as well.

Additionally, Federal tax revenues will increase in 2011. Exhibit 3 illustrates Federal revenues, outlays, and the budget deficit from the Congressional Budget Office, which assumes that President Obama's proposed budget is enacted. In 2008, tax revenues declined by approximately 4.0% of GDP due to the fiscal stimulus and the tax cuts enacted during the Bush Administration. As originally legislated, the Bush tax cuts are scheduled to expire in 2011. Also in 2011, as mentioned previously, the fiscal stimulus will be much lower versus 2010. Despite the fact that the Obama Administration's 2011 budget plan eliminates some tax increases that would otherwise occur, Federal tax revenue is expected to increase 16% in 2011 (for an additional \$350 billion of tax revenue) and another 14% in 2012 (for an additional \$340 billion of

### Exhibit 3 Federal Revenues, Outlays, and the Surplus/(Deficit)



As of 5 March 2010

Source: Congressional Budget Office projections

All fiscal years ending 30 September (e.g., fiscal year 2009 ended 30 September)

tax revenue). Interestingly, this tax increase is lower than it would be if nothing was done, as it exempts families making less than \$250,000 from the rollback of the tax cuts. If the current Administration's plan does not pass, the tax increases will likely be significantly more severe.

In aggregate, these numbers indicate that a large amount of money will move from the private to the public sector, and we could face a very large headwind from higher Federal tax revenue.

### The Current Economic Backdrop

Against these crosscurrents, the secular backdrop has not changed. We have exited the era of disinflation, a period in which interest rates declined from 1980 through the mid-2000s, and in which borrowing terms and conditions eased significantly at the peak of the credit bubble. This era will not be repeated.

Additionally, the United States has only just begun the process of deleveraging. The ratio of debt-to-GDP has declined from 360% to 348%, with the bulk of that coming out of the financials sector and in the consumer sector. Offsetting a large part of the deleveraging in financials and by consumers is government debt, which rose from approximately 55% in 2008 to 70% of GDP as of 31 December 2009. Borrowers in the United States can no longer be helped by lower interest rates and more accommodative terms and conditions, and the country in aggregate still needs to deleverage.

### Conclusions and Investment Implications

We currently see a number of positive factors in the economy: The Fed has already begun to exit markets without disrupting economic progress, housing appears to be stabilizing earlier and at higher levels than we expected, and fiscal stimulus will be a strong positive in 2010. We also see several negative factors: Fiscal stimulus becomes an economic headwind in 2011, potential tax increases loom, and these factors are set against an already difficult backdrop of deleveraging, which has just begun.

With all of this uncertainty, we believe that an investor must rely on fundamental, forward-looking research, as backward-looking analysis will focus on the era of disinflation, which occurred due to a very specific set of circumstances and will not be repeated. Given the uncertainty on the horizon, we also believe that investors should utilize robust scenario analysis applied through a disciplined investment process.

Through our analysis, what we continue to find (in both the debt and the equity markets) is that companies with robust free cash flow, balance sheet strength, and the resulting operational flexibility, which allows them to function in a good or bad economy, will be the winners against the new economic backdrop. We also believe we will continue to see ongoing differentiation between winning and losing businesses, as the U.S. economy evolves and as capital moves. For investors with the right expertise and process, we feel this differentiation offers significant opportunities.

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## Notes

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/>).

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## Important Information

Published on 6 May 2010.

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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