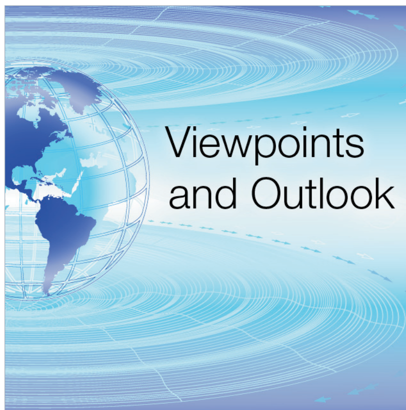
Capital Market **Viewpoints**

Lazard Capital Allocator Series

2011Q3 Outlook



The Lazard Capital Allocator Series Investment Team ("Investment Team") has taken recent economic, public-policy, and financial-market developments into consideration in constructing what it believes to be an optimal asset allocation for the third quarter of 2011. The Investment Team's methodology remains "top down" by nature. Historical relationships, combined with information contained in the futures markets, are used to develop a forward-looking world view that endeavors to anticipate major turning points in various asset-return cycles. The process tends to be gradual and directional in terms of specific asset-allocation recommendations.

A range of factors—from legislative changes to geopolitical events—are analyzed in the process of identifying and anticipating secular and cyclical adjustments in the relative performance of assets, both domestically and across countries. This information is applied to Lazard's decision rules for determining how and when to choose a style, location, and/or size of an investment, and whether to do so in a passive or active mode.

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In Search of Jobs and Growth

In two critical ways, the U.S. economy is proving to be the economy that will not: It will not accelerate at a robust pace and it will not produce jobs at a rate necessary to end what has become a true jobs recession.

It has also been the economy that will not quit. Despite a steady stream of headwinds, the U.S. economy has been in expansion since mid-2009. This is not the vigorous growth that has historically followed severe recessions. The seven-quarter average through March 2011 is only 2.8%, or about half what it might be on a historical post-recession basis. However, it nonetheless is sustained growth.

To date, the U.S. expansion has been fueled by gains in the manufacturing sector. While manufacturing suffered a severe setback in the second quarter of 2011 due to supply chain disruptions related to the Japan disasters, the sector is still expansionary. When autos are excluded from the data (the combined tsunami-earthquake-nuclear crisis in Japan interrupted the supply of auto parts in particular), manufacturing and industrial production data appear much healthier.

However, something is clearly wrong. Despite record profits, companies are sitting on their cash and are not hiring, at least not at a pace that will solve the currently high unemployment. Second-quarter data for jobs were disappointing. Private-payroll gains came in well below expectations (the addition of 54,000 U.S. payrolls in May was a third of the consensus forecast) while the unemployment rate increased to more than 9%. The multiple catastrophes in Japan plainly detracted from global economic performance. This was, however, an expected result from an unexpected shock—and likely a temporary shock at that.

Exhibit 1 highlights the jobless recovery in the United States. After a decline following the onset of the financial crisis, GDP figures in the United States have since returned to their 2008 starting point. However, U.S. employment levels have declined by 6%. The ability of the United States to produce the same GDP with 6% less employment, as illustrated in the chart, highlights the productivity gains and profit cycle that we are currently witnessing in corporate America.

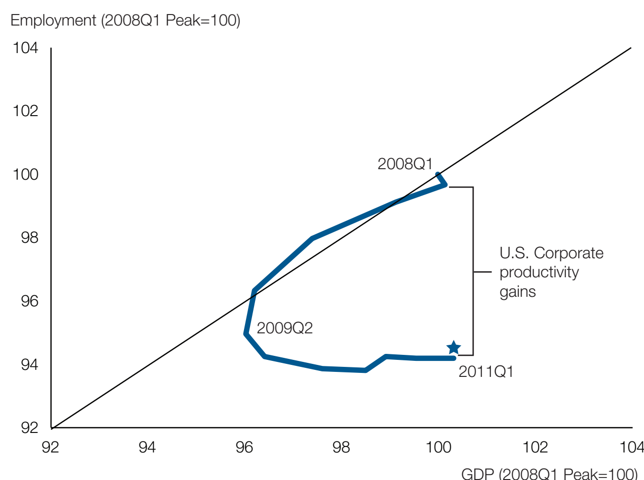
Probing a little deeper, there's something more systemic behind the sub-par performance. We believe companies are not hiring because they are hesitant to make enthusiastic bets on the future. Confidence took a big hit economy-wide when the financial crisis appeared in late 2008. Three years later, however, while some degree of confidence has been restored (as evidenced by a seven-quarter expansion), companies are refusing to dive back in. This may be due to the fact that a vicious cycle sparked at the beginning of the crisis remains in place.

The financial disaster first affected housing and the housing problem has yet to be resolved. Following a remarkable run-up in home prices, the housing market dipped, a critical level of homeowners went under water, mortgage defaults rose sharply, and a brutal foreclosure cycle was born. In response to this environment and the various challenges of the greater financial crisis, banks radically tightened their lending standards, holding back loans from all but the most creditworthy. Business cycles occur all the time and this was not the first time a housing bubble burst. But the problem now is that a classic boom-bust cycle appears to be stuck on bust, as the housing market has not cleared and the new up-cycle has yet to begin.

Despite various government interventions—from a massive spending stimulus to historic monetary accommodation—the housing market remains deeply depressed. Specifically, too many mortgages are going unpaid, foreclosure rates remain high, home prices have yet to recover in any broad sense, and banks are not lending near healthy levels. Of course, robust economic growth would remove many of the hurdles that are inhibiting the lending process and blocking the return of homeowner prowess. On the flip side, tepid economic growth and dismal jobs expansion are keeping those hurdles high. It is a classic Catch-22.

Corporate management teams are aware of the situation. We believe they see a sustained balance sheet crisis that may only be cured when savings and net worth increase to the point where lending risks diminish. They are conscious of a global

Exhibit 1: The Jobless Recovery: U.S. GDP and Employment Growth



As of 31 March 2011
Source: Exane BNP Paribas

economy that is still hard at work delevering, or reducing the amount of debt and increasing the level of capital necessary to finance investments. And they arguably see a consumer that is not yet ready to fully participate in the economy. Hence part of their conservative stance of not putting their cash to work to add to payrolls and expand operations.

Worries and Surprises

Businesses—and markets in general—also might be well aware of policies that are inhibiting the repair process, and they might be keeping risk tolerance low until the policy formula turns more favorable to economic growth. On the state level, we are seeing some signs of a turn toward constructive economic policy. In the face of large budget shortfalls, many states are opting to cut spending rather than raise taxes, in order to bridge their financial gaps. This can be considered positive structural change since the cure is not antithetical to growth. On the federal level, it is also a welcome development that spending cuts (in the face of historically high debt levels) have become the central debated policy, while spending programs long considered too hot to touch, such as Medicare and Social Security, are on the table.

At the same time, however, the existing U.S. federal policy formula is arguably prohibitive to growth. The current level of spending to GDP projects to rise to more than 25% in 2011, well above the near 21% level registered in 2008, as compared to revenues that are typically about 18% of GDP. In part this means that a high proportion of the economy is lodged in the less-efficient public sector. It also points to an increased threat of higher future tax rates to cover the increased outlays. The regulatory wall has also grown, most recently with the addition of sweeping health care legislation and 200 new rules as per the Dodd-Frank financial reform. In addition, several key free-trade agreements remain incomplete, such as South Korea, Panama, and Colombia.

New data also show that the U.S. debt situation is projected to deteriorate further. According to a report from the Congressional Budget Office released in late June 2011, publically held U.S. government debt is projected to top 101% of GDP by 2021 and 190% of GDP by 2035. Such statistics will provide additional fodder to the ongoing debt limit talks in Washington, another source of market worry. On its face, the debt limit debate offers a choice between more U.S. debt if the limit is raised, or a U.S. debt default if the limit is left as it is. In more normal years, the debt limit would be increased pro forma. But with spending such a highly charged issue in Washington—if not worldwide—the debate has become quite heated. In the end, there most likely will be a tradeoff between a higher debt ceiling and some form of spending limitation, the specifics of which could alter market returns. For instance, significantly reduced spending levels would positively impact the growth forecast and hence would be a boon to equities over bonds. In our opinion, fears of a U.S. default are overstated. The United States is not Greece, and, in the worst case, the U.S. Treasury will continue to make interest payments on debt from incoming tax receipts. This is a liquidity problem, not a solvency issue.

Businesses and markets also seem to be fretting the end of QE2, or the U.S. Federal Reserve's (the Fed's) second round of quantitative easing. Both QE1 and QE2 were attempts to provide government leverage to offset private sector deleveraging following the housing crash and financial implosion. The Fed's method was to expand its balance sheet through the purchase of long-term U.S. Treasuries, in turn putting high-powered money into circulation. Thus far, the evidence shows that, while these programs may have helped avert a second economic collapse, they failed to induce banks to lend at pre-crisis levels. Still, there is concern that the end of QE2—and any reduction in the Fed's balance sheet—will pull a cushion out from under the economy. From here the worry is characterized by increased uncertainty. Will the removal of QE2 make the economic rebound even more anemic and thus prompt yet another Fed intervention?

Looking more broadly, the debt crisis in Europe has been a source of worry for more than a year now. However, the situation has come to a point where a major default—specifically a Greek default—would be unsurprising. And while a sovereign default would certainly be disruptive to markets and the global economy, in the broader scheme it might expedite the application of a cure while removing some uncertainty from the markets. The peripheral European nations have spent to a level where deficits are unsustainable and the current level of debt is hazardous. It is difficult to resolve insolvency by providing more liquidity. The long-term solution is dramatically lower levels of public spending. Until that medicine is applied, however, the sovereign bailouts will continue while the public debt is restructured at a lower value—all to the detriment of economic growth.

China and the emerging markets are delevering, too, making for yet another source of market worry. However, the growth stories in emerging markets remain positive so that a brief slowdown should not represent too much of a headwind. If economic growth slips temporarily to 5% from 6% in the emerging markets overall, and to 8% from 9% in China, the pace of growth in each case can still be considered vigorous.

Meanwhile, these corrections would help allay fears that rapid growth in the current accommodative global environment will spark much higher future inflation.

The idea of an October surprise has been around U.S. politics for a long time. However, an increasingly competitive 2012 election cycle may force a surprise much earlier. In order for U.S. economic growth and job creation to reach what could be considered favorable levels for the re-election hopes of the current administration—sustained economic growth of greater than 3% and an unemployment rate at 7% or below—significant and effective stimulus will need to be applied. It may not necessarily be government spending; it may be pro-growth stimulus for the private sector, including less government spending, regulation, and taxation.

The problem is that it will take time to both legislate and enact such policies and, once enacted, it will take time for new economic incentives to positively affect the data. But a near-term upside surprise is certainly possible. Such a surprise could include an immediate infrastructure-spending initiative, a corporate tax cut (at more than 39%, the U.S. statutory combined corporate tax rate ranks second-highest among developed countries, behind Japan), a dramatic spending cut initiative, or perhaps a scheme for the repatriation of foreign earnings of U.S. companies (which could return an estimated $1 trillion in cash to the U.S. economy). Did the late-June announcement by the International Energy Agency that its members will release 60 million barrels of oil from their strategic petroleum reserves—with the United States covering half of that amount—mark the start of the surprise season? Over the coming quarters, it will be difficult to discount most any policy move from the political calendar.

Investment Insights

There is no shortage of bricks to add to the wall of worry these days. In terms of asset allocation, this is a challenging environment. We do, however, think it is manageable. Stock markets corrected about 7% in the second quarter, following a two-year gain of more than 90% (as per the Dow Jones). Corrections happen, and based on a forecast of continued—though below potential—economic growth, we believe a slight bias toward equities over fixed income instruments is warranted for the third quarter. Much of the market worry has been factored in already. Should any policy surprises occur, they may well be ones that are beneficial to economic growth and job creation, and hence stocks over bonds. In addition, the profit cycle still exists, and profits today are at record levels. Although cash is being stockpiled rather than deployed, corporations could easily turn more aggressive should a positive policy shock occur.

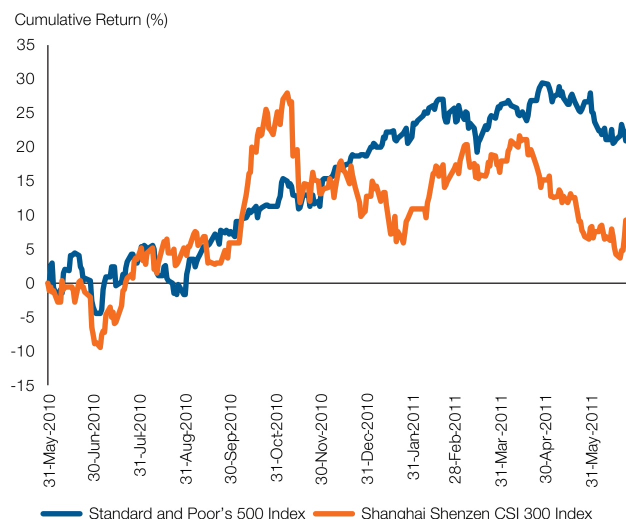
The rationale for equities over fixed income is bolstered from the perspective of bonds as well. Bond yields plummeted in the second quarter as market worries mounted relative to anemic economic data, the heightened debt ceiling debate, and the somewhat unclear direction of Fed policy. One would then expect yields to rise as more certainty greets each of these variables. As mentioned, the debt limit debate likely will be solved with some tradeoff between a higher debt ceiling and spending cuts; Fed policy is now clear in that QE2 will end as scheduled while the federal funds rate will hold near zero; and economic expectations are currently so low that any improvement in the data will look like an upside surprise—to the expected detriment of bonds relative to stocks.

In short, while we are not wildly bullish, and while we acknowledge there is a cap on developed-market growth, we believe there will be enough of a continued economic expansion in the quarters ahead to warrant a tilt toward equities over bonds.

Looking globally, as outlined, we see no reason to panic about what we expect will be a minor retreat in emerging markets and Chinese growth. In fact, this may already be reflected in expectations as the Chinese equity market has lagged the U.S. market over the past year, shown in Exhibit 2. We believe this is a secular story, where China and the emerging markets take on behaviors more traditionally associated with the developed markets, consuming more, spending more, investing more, and importing more—and thus attracting more capital investment.

On the other hand, developed market investment outside of the United States may be less attractive. This is due in part to

Exhibit 2: China versus U.S. Equity Markets



As of 30 June 2011

Source: Bloomberg Markets

the secular shift toward the emerging markets, but, more immediately, it is tied to the debt woes of the peripheral European nations. In Europe, we expect the delevering period to be protracted, painful, and growth-prohibitive, while any sovereign default will have a negative near-term impact on markets and the global economy. Therefore, we remain bearish toward Europe overall—and more specifically toward European financials and the euro.

Japan, as stated, has only added to the 2011 global economic soft patch. We do, however, believe the relative attractiveness of Japan remains very high in the aftermath of the combined disasters. Last quarter, we introduced plans to increase our exposure to Japan in order to take advantage of the nation's rebuilding phase. This was a tactical move that we enacted primarily through non-traditional equity investments. For the third quarter we will increase our Japan exposure even further, moving from a neutral weight to an overweight. This is not a secular shift, but a sustained tactical effort to exploit a unique investment opportunity. In terms of valuation, we believe Japan is now very cheap versus its own history. (On a price-to-book level, Japanese stocks have never been cheaper.) Japan's liquidity situation is very good and improving, with cash rising as a percentage of the market. Further, key Japanese economic indicators—production, consumption, exports, retail sales, sentiment, and loan growth—are all on the rise. When you couple this with the opportunity to cash in on a national rebuild, there is a solid case for a sustained, although not indefinite, increase in Japan exposure.

In summary, the world is stuck in a prolonged delevering cycle, with economic growth either coming in below potential or edging lower. Nevertheless, an economic expansion exists, and it has yet to be interrupted in a recovery cycle that has been fraught with obstacles and unexpected shocks. So while a case can be made for continued caution, there is no need to overstate that case.

As always, we remain confident that our versatile framework will reward risk-takers who stay the course with attractive relative returns over time.

Lazard's 2011Q3 Asset Class Viewpoints

	ATTRACTIVE		FAIR VALUED		UNATTRACTIVE
EQUITY Cap		Large Cap	Mid Cap Small Cap		
Region		Japan United States	Asia-Pacific ex-Japan Emerging Markets	United Kingdom Continental Europe	
Style	Non-Traditional	Growth	Value		
FIXED INCOME	Non-Traditional		Cash Credit		Sovereign Debt

For illustrative purposes only.

Non-traditional Investments

THEMATIC	CONTRARIAN	DIVERSIFYING	DISCOUNTED
Industrials	Health Care	U.S. Corporate Bonds	Closed-end Equity Funds
Agribusiness	U.S. Dollar Overweight	Consumer Staples	
Water Infrastructure	Technology	Gold	
Materials	Japan	Utilities	
Taiwan		Gold Miners	
China			
Chile			
Consumer Discretionary			
U.S. Savings Rate Basket			
U.S. High Free Cash Flow Basket			

As of 30 June 2011

For illustrative purposes only.

Important Information

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An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond's maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply.

Investments in closed-end funds are non-redeemable and are subject to the same risks as other publicly-traded equity securities. Sometimes, however, there may be no public market for units of closed-end funds. The shares of closed-end funds, and exchange-traded funds ("ETFs") may trade at prices at, below, or above their most recent net asset value. There is no guarantee that a fund's discount will ever be narrowed or eliminated. Additionally, the performance of an ETF pursuing a passive index-based strategy may diverge from the performance of the index. Exchange-traded notes ("ETNs") may not trade in the secondary market, but typically are redeemable by the issuer. Unlike ETFs and closed-end funds, ETNs are not registered investment companies and thus are not regulated under the 1940 Act. In addition, as debt securities, ETNs are subject to the additional risk of the creditworthiness of the issuer. ETNs typically do not make periodic interest payments. An investment in these types of instruments is indirectly subject to all the risks associated with the investments made by the closed-end fund, ETF, or ETN.

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