

Capital Market **Viewpoints**

Lazard Capital Allocator Series

2012Q2 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 second quarter of 2012. 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 the Investment Team’s 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.

A Good Start

We entered the first quarter of 2012 cautiously optimistic that the European sovereign crisis would be contained and that the global spillover effect would be minimal. We also felt that the fundamentals in the United States had turned positive enough to warrant a brighter take on the domestic economy. Each view proved correct.

In late February, the European Central Bank (ECB) again confirmed that it will intervene to whatever level is necessary to avoid a continent-wide banking collapse. Expanding on the Long Term Refinancing Operation (LTRO) it introduced in late 2011, the ECB extended \$712 billion (€529.5 billion) in ultra-cheap three-year loans to approximately 800 lenders (up from 523 in December). In essence, the ECB has undertaken a massive liquidity operation, similar in character to the quantitative easing measures taken by the U.S. Federal Reserve (the Fed) in recent years. With the ECB signaling that it will purchase any non-impaired securities in the Eurozone, they have become the buyer of last resort. With an eye on the short term, this policy has helped prevent a credit crisis from engulfing the debt-strained Eurozone.

It is difficult to imagine a wholesale move by the European Union members away from the social-spending structures that precipitated the sovereign crisis. Yet some of Europe's troubled nations are coming to understand the policy formulas necessary for the eventual sustainability of their debt, including lower levels of spending, a reduction in the entitlement state, labor reforms that return power to the employers, and tax structures that spark economic activity and growth. In Italy, for example, newly installed Prime Minister Mario Monti has introduced meaningful austerity and growth measures—including labor and pension reforms—that are intended to balance the nation's budget by 2013 and produce a surplus in the following year. With a debt-to-GDP ratio of 120%, the second largest in the Eurozone following Greece, that is a tall order. However, in our view, it is encouraging that Europe's third-largest economy is embracing policies that will encourage growth, reduce black market economic activity, and move Italy away from the brink.

In the United States, ironically, policies enacted in recent years have moved the nation deeper into sovereign-risk territory. Nevertheless, the U.S. economy has continued to expand following the deep recession, with key indicators either turning more robust in recent months or remaining at expansionary levels: The Institute for Supply Management (ISM) Non-Manufacturing Index has expanded for 26 straight months through the early March 2012 reading, and while the ISM Manufacturing Index has fluctuated up and down in

recent months, it remains comfortably expansionary. Retail sales have grown for 19 of the last 20 months through February 2012, and spiked 1.1% in February. U.S. bank lending for the final quarter of 2011 increased at the highest level in four years, according to the FDIC's most recent report. Jobs expansion has also turned more vigorous. Payroll jobs increased by more than 200,000 a month in December, January, and February, an above-consensus trend that is consistent with a labor-market turnaround. Over the same period, the unemployment rate inched down to 8.3%.

Taken together, the lack of a Lehman-level event in Europe and the apparent solidification of the expansion in the United States returned some consistent enthusiasm to the markets: The S&P 500 Index notched its best annual start since 1997 through the first two months of the year; the NASDAQ hit an 11-year high in late March; the Dow pushed above 13,000 in late February, the first time it has been in this territory since May 2008; and major European stock markets have recovered much of the ground lost since the sovereign crisis erupted last summer.

As long as the ECB remains accommodative, and as long as the U.S. economic data—in particular the jobs data—confirms an expansion that is on firm footing, there is no compelling reason to fundamentally change our opinions heading into the second quarter. There is, however, good reason to be extra watchful for sudden shifts in the data and market sentiment in the months ahead—and noise has a lot to do with it.

Static Cling

There is always some level of noise in the investment markets, in particular when market fluctuations are viewed within a short time frame. However, there are times when the noise gets loud and tends to linger, a combination that makes extracting information from the markets more difficult. In our view, the United States is currently at this point.

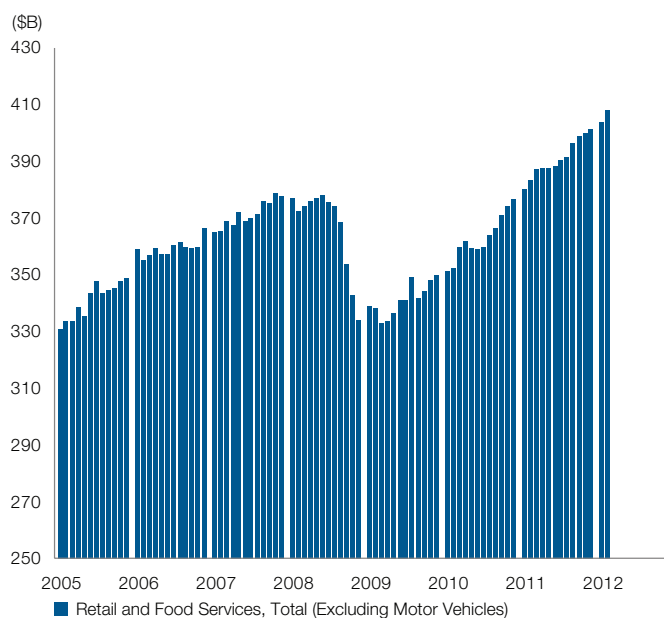
For starters, there is the noise of weather. The United States just experienced its fourth warmest winter on record (going back to 1920). The national temperature for February 2012 was five degrees warmer than that of the past five Februaries. For much of the nation, the second half of the winter felt like a prolonged early spring, with some late-spring days thrown in. So rather than turn on their heaters, many Americans opened their windows—and changed their behavior.

According to the U.S. Energy Information Administration, the number of heating degree-days, which is a measure of space-heating requirements, declined 17% in January and February. That potentially equates with altered economic activity in several ways: Money not spent by households and businesses

on heat might simply be spent elsewhere. Consumers might venture out to make purchases they normally would not make during the winter. We note that auto sales rose 1.6% in February, and were 6.9% higher in February than a year earlier. Outdoor construction activity may elevate as the days allowable for that activity increase. Further, more workers may report to work than would be the case with poor weather.

The upshot is that spending and output that might have occurred in the spring may have been pulled into the winter, with the prior season in effect stealing economic activity from the coming season. The recent increase in retail sales is illustrated in Exhibit 1. None of this, however, is clear cut. It is noise. While spending increased in several areas because of the warm weather, it decreased in others, such as on skiing and winter apparel, and likely on heating oil. There also are high gasoline prices to take into account. It remains a question whether high gasoline prices entirely offset any gains consumers experienced from lower heating bills. There is also the added noise of seasonally adjusted data: Simply, all government data—including housing, employment, and GDP statistics—that are adjusted to take into account the expected impact of weather during a particular season may have been misestimated due to the unseasonably warm winter. In other words, the seasonally adjusted formulas that look for weaknesses in the data may not have worked as well over the recent winter months, the result being that a small increase in the data could translate to a significant and misleading seasonally adjusted increase. We will be monitoring this impact

Exhibit 1: Retail Sales



As of 29 February 2012

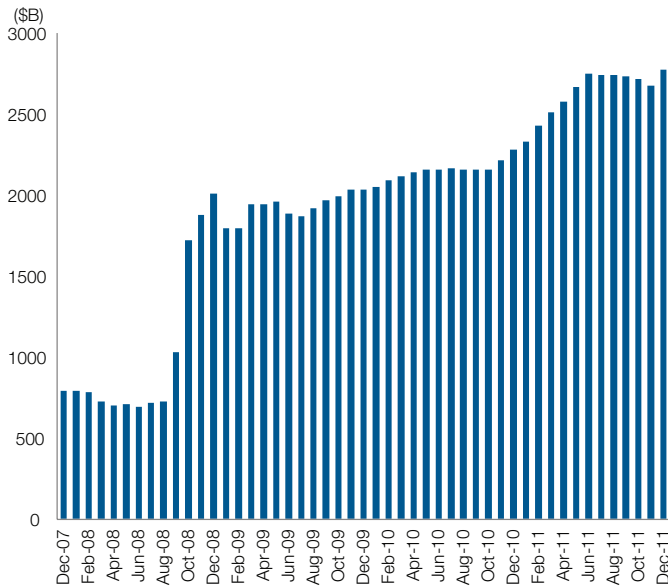
Source: The United States Census Bureau

throughout April, as we believe that seasonal adjustments that inflated economic data from December 2011 through February 2012 will become a headwind in the March through May 2012 reporting period.

Related to the noise of seasonal adjustments is the noise of a new recurring pattern: In each of the last two years, the economic data has looked bright (or brighter) at exactly this point in the calendar year, only to slump in the middle and later parts of the year. Some economists attribute this to the severity of the recent recession. They suggest that the nature of the recession was so negative that it has distorted the usual patterns of seasonal adjustment, producing an upward bias in the economic data in the last and first quarters of the year and a downward bias in the second and third quarters. This new pattern conforms nicely with market volatility across the previous two years. While it is still hypothesized as to whether these distortions are now hard-wired into the data, we may be headed for a third-straight episode where new data look excessively bearish relative to previous overstated data, sparking an investment-market retreat.

Next is the noise of monetary policy, which is more of the markets reacting (or overreacting) to every word uttered by U.S. Federal Reserve Chairman Ben Bernanke. The markets are obsessed with determining when the Fed will discontinue its massive liquidity program, and the manner in which it will end it. Most observers envision three scenarios, only one of which is positive: If the Fed retreats too quickly, the economy could stall and deflation could emerge; if it acts too slowly, higher future inflation could lock in; and if it performs its withdrawals deftly, the economic expansion might continue uninterrupted, with inflation held in check. However, since the Fed can be vague about its intentions, markets tend to parse the Chairman's every word, triggering hikes in the value of the dollar and slides in gold, or vice versa. As of the March 13th Federal Open Market Committee (FOMC) meeting, what we do know is that the Fed now recognizes the viability of the expansion (which greatly lessens the chance of another round of quantitative easing) and that it "...expects to maintain a highly accommodative stance." With the fed funds rate now close to zero, the Fed would still be highly accommodative if it lifted the rate by a quarter percentage point or more. Based on its acknowledgment of improved economic conditions, many questions remain unanswered. Will the Fed begin hiking rates in 2012? Will it begin unwinding its balance sheet, shown in Exhibit 2, in the near term? If so, in what manner and how fast? What is certain, in our view, is that the markets will amplify every Fed signal. In other words, the noise will continue.

Exhibit 2: Total Federal Reserve Balance Sheet



As of 31 December 2011

Source: U.S. Federal Reserve

Finally, there is the noise of politics. Until the results of the U.S. presidential and congressional elections in November are known, businesses, households, and investors will be left guessing regarding the makeup of U.S. tax and budgetary law, the fate of new entitlement programs, and the fundamental policy direction of the country. Currently, U.S. tax rates are scheduled to go up significantly in December 2012 when the tax cuts of 2003, originally scheduled to sunset in 2010, will end their two-year extension period. The result would be a top-bracket income-tax hike from 35% to 39.6%, a capital-gains tax increase from 15% to 20%, and a dividend tax surge from 15% to 39.6%. Taxes also are scheduled to increase in 2013 when key provisions of the health care reform, passed in 2010, kick into gear. Additionally, there are plans for new millionaire and carried-interest taxes along with higher estate taxes.

With the election outcome impossible to call at this point, the U.S. tax situation is up in the air. However, should the polls help narrow-down the election result in the coming months, and should that result lock in the probability of significantly higher taxes in 2013, market participants could initiate action in the near term. Specifically, they could bring income recognition to the present where taxes and regulations are lower, producing a sense of false prosperity and, therefore, potentially weakening 2013 results.

The Productivity Inflection Point

Surges in productivity, or output per hour, are common both in good and bad economic times. In an economic slump, businesses retract, and frequently will reduce the size of their workforce or attempt to compete with the workforce that they have. As a result, more is required of the workers on hand—the same laborers who may very well hold their jobs increasingly dear—and output per hour increases. Alternatively, when economies surge, businesses take on more workers and enlarge their operations. But here, productivity also rises, as employees are incentivized to produce more, both to keep up with vigorous increases in demand and to claim the new rewards that appear in robust expansions.

However, when economic performance is neither vibrant nor recessionary, falling somewhere closer to mediocre, productivity can take a hit. More workers may be hired in this environment, and business expansion may occur. However, without the spark of vibrant demand or attractive new rewards, the incentives to elevate output per hour remain low. In turn, this produces a negative feedback cycle where lackluster productivity fails to invigorate an economy, and a modest economy is not able to stimulate productivity.

What might seem an anomaly in the recent performance of the U.S. business sector is actually an extremely predictable outcome: How is it possible that U.S. corporations, following a severe recession, have been able to produce record profits as a percentage of GDP, all while economic activity has been anything but stellar? The answer is productivity. Fewer workers drove up their output in order to survive in an increasingly competitive jobs environment and difficult economy. As a result, corporations gained on the back of higher productivity and lower overhead.

We believe the outsized-profits stage of this story, however, is in danger of coming to an end. Thinking beyond the presidential election and the uncertainty of an election-year economy, if the less-efficient U.S. public sector swells even more at the expense of the private sector, it may be difficult to attain economic growth in excess of what it has been for much of the recovery—near 2%. However, as long as there is growth, and as long as the future policy mix is somewhat predictable (meaning businesses can plan for it), unemployment will continue to slowly decrease, but is not likely to reset to historically low levels. This scenario points to a mediocre result of lower unemployment and only moderate growth, which we have described as a potential breeding ground for lackluster productivity.

Investment Insights

Our shift away from neutral and toward risk for the first quarter of 2012 produced strong results across the strategies. Heading into the second quarter, we will continue a bias toward equities and an underweight to fixed income securities, although we will take our foot off the risk accelerator and slightly reduce our equity exposure. In general, we believe there is enough positive economic momentum to maintain our equity overweight. However, we are cognizant of the potential for a slight statistical slump, and for skittish investing behavior in a noisy environment. For instance, even a small uptick in the unemployment rate from 8.3% to 8.4%, or slight downward revisions in production measures or GDP, could be interpreted as very negative events, eroding stock market confidence and encouraging investors to seek less risk.

Regarding equities, we will slightly reduce our exposure to large-cap stocks in the United States as well as in emerging markets, including Asia. While we are bullish toward China for the long run, we feel the country's moderate slowdown has yet to run its course. Further, with the world not performing to potential, it is not surprising that the world's largest exporter (along with other exporters in emerging markets) is feeling the slack in demand. In Europe, the recent upside in equity markets can be explained in part by an interventionist ECB and the sense among investors that worst-case scenarios may be avoided. Valuations in Europe are currently at historically low multiples, suggesting it is still an inexpensive market on a relative basis. Nevertheless, we believe the growth prospects for the region are not exciting, and it will still face deleveraging headwinds. As a result, instead of implementing a general approach to the continent, we will be selective, for instance investing in countries like Italy that are moving rapidly toward meaningful debt reduction and pro-growth regulatory and tax reform.

We also will remain discerning with our sector selections and custom baskets. In terms of sectors, financials have moved back onto our radar screen. As one of the most undervalued sectors, financials have been attractive—and prohibitive—for some time. With major U.S. banks now lending at a healthier clip in recent months, and with some making moves to return capital to shareholders, the sector appears attractive, in our view. As related to productivity, we will screen industries and regions, including countries and states, to determine where the productivity gains may be the highest, or where for various reasons the productivity variable is less of an influence on output and profits.

Another consideration for equities suggests there is also a case for moving away from dividend-paying stocks. If the end

of the 2003 tax cuts becomes evident, the tax on dividends would soar from 15% to 39.6%. Under this scenario, dividends would be at a clear disadvantage to other return-delivery vehicles, also removing some of the luster from dividend-paying stocks.

Our underweight position to traditional fixed income was a key driver of our positive first quarter performance. Given the recent equity market strength, we will increase our exposure to fixed income, but remain underweight. We should also note a rising risk component within the fixed income asset class. With long-term U.S. Treasuries now at historically low yields, the tools with which to mitigate volatility have significantly decreased. Consequently, we are compelled to seek other investments that may work as hedges against risk, and also to review our convictions relative to all traditional diversifiers, including gold.

Obviously, gold prices have soared over the volatile past decade, and to a large extent across the financial crisis and its aftermath. Currently, the renewed sense of order in Europe, the solidification of the U.S. expansion, and the subsequent bond market sell-off have led to some weakness in the price of gold. Nevertheless, we will maintain our exposure to the metal, as it provides a hedge on inflation and diversification from equity risk. Further, within the shrinking pool of risk-diversification offerings where long Treasuries offer less diversification than in the past, we still believe gold offers good protection against political and fiat money risk, as illustrated in Exhibit 3.

Exhibit 3: Gold versus 10-Year U.S. Treasury Yields



As of 30 March 2012

Source: Bloomberg

When 2012 is behind us, it may very well be that GDP in the U.S. averaged 3% or more for the year. That is satisfactory for most years, and following a lengthy period of near 2% expansion, it would be a refreshing result. However, we doubt anyone will claim of having had a smooth sail through the markets in 2012. There are many signs that the next two quarters will be marked by rapid market fluctuations. In our view, the

key is to stay in front of the markets, and not be forced into a reactive mode. With our allocations for the second quarter, we believe we are well-positioned for the year ahead.

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

Lazard's 2012Q2 Asset Class Viewpoints

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

For illustrative purposes only.

Non-traditional Investments

THEMATIC	CONTRARIAN	DIVERSIFYING	DISCOUNTED
Energy	Japan Small Cap	U.S. Corporate Bonds	U.S. Large-cap Closed-end Equity Fund
Technology	Italy	High Yield	China Closed-end Equity Fund
U.S. Savings Rate Basket	European Financials	Gold	
Industrials	Private Equity		
U.S. High Free Cash Flow Basket	U.S. Financials		
Agribusiness			
Korea			
Consumer Discretionary			

As of 31 March 2012

For illustrative purposes only.

Important Information

Published on 10 April 2012.

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Equity securities will fluctuate in price; the value of your investment will thus fluctuate, and this may result in a loss. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Small- and mid-capitalization stocks may be subject to higher degrees of risk, their earnings may be less predictable, their prices more volatile, and their liquidity less than that of large-capitalization or more established companies' securities. Emerging market securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging market countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in emerging market countries.

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. High yield securities (also referred to as "junk bonds") inherently have a higher degree of market risk, default risk, and credit risk.

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.

Past performance is not a reliable indicator of future results.

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