OCTOBER 2009

Outlook for Global Equity Markets

Optimism about the outlook for the global economy led to an extended rally in virtually all risky assets during the third quarter, and stock markets continued to perform well, showing strong gains since the March 2009 trough. However, while global stocks have risen over 65% from the March lows, they still remain more than 30% below the peak in October 2007. In the United States, the housing market showed further signs of stabilization due to support by the government's incentive for first-time homebuyers and low borrowing costs. The recent pickup in home sales and prices also added to evidence that the housing slump is easing. However, some investors remained cautious due to weakness in consumer spending and uncertainty over the outlook for the labor market, which may weigh against any sustainable economic recovery. European stocks outperformed the rest of the world, as France and Germany, the two largest economies in the region, returned to economic growth in the second quarter. Signs of recovery in the housing market in the United Kingdom also set a positive tone for its stock market, with financial stocks leading the rally despite lingering concerns that a combination of a large fiscal deficit and weakening pound sterling may trigger inflation. Asian markets followed their U.S. and European peers higher, partially supported by a rebound in Chinese stocks, as the economy in China appeared to gather pace with strong growth in the private sector. Equities in Japan, however, lagged amid uncertainty over the new government's economic policy. The strengthening yen also fueled concern about the country's export-dependent economy. By sector, financial stocks performed strongly, as credit and financial markets continued to normalize and low funding costs continued to help profitability. The materials sector also performed well, as improving sentiment regarding global growth boosted commodity prices. The strong performance in the information technology sector was mainly due to a positive outlook for the global semiconductor markets. Meanwhile, defensive sectors, such as telecom services and utilities, underperformed during the quarter amid optimism over the economic recovery.

U.S. EQUITY

Differentiation Has Just Begun

In the third quarter, we moved further into economic normalization. In spite of many investors' evident willingness to apply disproportionate weight to the most recent economic and market observations, we continue to believe that we are at the beginning of a multi-year period of differentiation. Going forward, we believe that we will see significant dispersion of returns among winners, survivors, and losers, as the United States transitions from the era of disinflation to an economy driven by something other than excessive consumption and cheap, readily available leverage. Over the past investment cycle, the markets significantly underemphasized balance sheet quality and cash flow strength because of the vast availability of leverage.

It should be clear that no trend is a straight line. Rather, we expect to see intermittent periods, such as the third quarter of 2009, in which risk is embraced in the hope that cash flow will follow. However, we believe that for many companies the cash flow will not come. Our investment focus is unchanged: We continue to invest in companies with robust organic cash flow, strong balance sheets, and the operational flexibility that results from these factors.

THE QUARTER BEHIND US

As we forecasted in our third-quarter outlook, house prices did increase, and a number of other factors aligned to drive a substantial rally in credit and equities. As we outlined in a conference call in mid-August,[1] we see the potential for these gains to be sustained and even extended in the near term, as house prices increase further, credit spreads continue to compress under the weight of direct U.S. Federal Reserve (the Fed) intervention, inventory depletion dissipates, and fiscal stimulus spending features more prominently than it has to date.

The third quarter can be characterized generally as one in which the good news outweighed the bad:

- House prices rose. As reported in the last week of the quarter, the S&P/Case-Shiller 20-City Composite Index rose by 3.6% from the end of May to the end of July. The increase in prices was driven primarily by the decrease in mortgage rates over the period from October 2008 through May 2009, which drove demand for houses. The decrease in supply resulting from the various foreclosure mitigation efforts is likely to benefit results in 2010.

- Credit markets continued to recover. The cost of credit continued to decrease through the quarter, with the Moody's Baa Corporate Credit Index yield falling to 6.17%, only 53 basis points above the all-time low observed at the peak of the credit bubble and roughly in line with levels last seen in the 1960s.[2] The decline in the cost of funds was driven by lower levels of debt issuance and by increased demand from investors. In the third quarter, over $110 billion flowed into long-term fixed-income funds, according to the Investment Company Institute (ICI), up significantly from $89 billion in the second quarter, and $53 billion in the first quarter. During the same time period, money market outflows were $236 billion. Roughly $70 billion of the balance flowed into deposit accounts, according to the Fed, as institutional and retail investors saw incremental yield pick up from basically anywhere other than money market funds.

- Earnings were better than expected. Even though the upside surprise to earnings was driven largely by expense cuts, revenue was roughly in line with consensus expectations for the second quarter. We saw numerous anecdotal indications that companies have completed the destocking of inventories and reached the point where they actually need to add employees to meet current demand. The results we see this quarter and next will be key to determining if those anecdotes actualize into a trend.

THE QUARTER AHEAD OF US

Our key considerations for the fourth quarter are:

- Credit markets will be on a knife's edge waiting to see how the Fed winds down its purchases of Mortgage Backed Securities (MBS). At the 23 September Federal Open Market Committee (FOMC) meeting, the Fed indicated it would reduce its purchases of MBS gradually, with purchases continuing through the first quarter of 2010. At the prior FOMC meeting, the Fed had announced it would stop purchasing U.S. Treasurys at the end of October 2009. As of 30 September 2009, the Fed had purchased $260 billion of Treasurys. While this amount is much smaller, relative to total issuance, than the amount of MBS purchased by the Fed, we believe the Fed will be watching the market dynamics to see if the cessation of purchases materially impacts interest rates.

  Over the next six months, the single biggest risk factor on our radar will be how the Fed handles this exit. We have discussed before the degree to which the Fed's purchases have driven credit investors out of the risk and maturity curves, pushed borrowing rates down, and allowed companies to refinance their debt. In the twelve months ended 30 September 2009, the Fed and Treasury have purchased or financed $2.235 trillion of asset purchases. Even excluding the TARP-related investments, direct intervention in credit markets totals just under $1.6 trillion—a massive amount of funding that has benefited the markets.

- House prices have perhaps one to two months of upside left. The next Case-Shiller home price data, which will be released at the end of October, will reflect virtually all of the benefits of the decreases in mortgage rates over the last year. The November release will reflect mortgage rates that were in force as recently as July, when they were up 50 basis points from their lows, implying a monthly payment approximately 5% higher per dollar of borrowing.

  We believe that the end of the tailwinds derived from lower rates will combine with a seasonality factor. Typically, home sellers attempt to time their sale to match demand. Demand tends to be highest in the spring and summer months, when it is easier for families to move without disrupting school schedules and to avoid unfavorable weather. Unfortunately, banks that foreclose on homes do not have the luxury of timing borrower defaults. As a result, they generally try to sell homes year-round. Sales in the winter months, however, are unlikely to be met with adequate demand to sustain prices, especially as tax credits expire and interest rate reductions start to reverse.

- Fiscal stimulus will increasingly benefit the economy. The funds committed as part of the American Recovery and Reinvestment Act of 2009 (ARRA) are now starting to have an impact, which we believe will last through 2011. As a reminder, the stimulus package totaled $787 billion, of which $288 billion was in the form of tax relief, $275 billion was for contracts, grants, and loans, and $224 billion was for entitlements such as Medicaid and student loans. Of the $288 billion of tax relief, only $62.5 billion had benefited taxpayers as of the end of August.[3] (This makes sense, as the tax cuts are applied over a number of years, with a foregone revenue "cost" for each year.)

  Of the $499 billion targeted for spending, $308 billion worth of target projects has been announced, $250 billion is available for funding, and $107 billion has been paid out.[3] Therefore, the amount of cash likely to flow in the coming quarters is sizable, with every $140 billion portion equating to about 1% of GDP. Going forward, we believe this will have a meaningful impact on employment trends and, consequently, on corporate revenue.

CONCLUSION

While conditions for investing are substantially better compared to what they were a year ago, uncertainty continues to cloud the outlook for the quarters ahead. This environment demands that managers rely on forward-looking, fundamental research to make investment decisions. As we move toward a new economic backdrop and the era of disinflation fades into history, we believe that our investment focus on robust cash flow, strong balance sheets, and the resulting operational flexibility will continue to deliver strong results.

Written by:
Ronald Temple, Managing Director, Portfolio Manager/Analyst

EUROPEAN EQUITY

Constructive, But With Caution

European equity markets were very strong in the third quarter. Expectations that Europe would lag the rest of the world in the recovery cycle have so far proved to be unfounded, with Germany and France emerging from recession more quickly than anticipated and ahead of many other developed markets. During the quarter, investors became more convinced that economic recovery had taken hold in Europe, with banking markets normalizing, issuance rising, and a renewed appetite for riskier assets.

Within the European equity market, the surge concentrated initially on smaller-capitalization, highly cyclical, low-quality companies. This type of performance can occur in the early stages of a market recovery; however, stocks that bounce the most early on in the recovery do not necessarily go on to lead the market. For example, after the technology bubble burst, many technology stocks rebounded from their lows, yet did not outperform for years afterwards.

We believe this pattern of market performance offers investors the opportunity to gain exposure to high-quality stocks that have underperformed over the short term, on a relative basis, but are likely to resume market leadership as performance broadens out across the market. Already we are seeing some evidence of this in Europe, with a combination of both cyclical stocks and defensive stocks among the best and worst performers for the month of September—a trend that we anticipate will continue.

We can now see value across the full spectrum of the market among high-quality companies in a wide range of sectors. As a result, we remain quite constructive about the market overall, but would still urge some caution. We think investors should pick carefully through the market at this time, as the heightened expectations of recovery may lead to disappointment in the final quarter of 2009 and into next year. We continue to believe that the recovery is likely to be sporadic and more stock-specific than what the market is factoring in.

Company results and outlook statements over the next few quarters will be important for the sustainability of the rally. In many cases, the stock price rebound has been a result of the expansion of investment multiples and not an improvement in the underlying revenue outlook of a company. Consensus earnings have been difficult to gauge, and we prefer those companies with either visible and sustainable earnings, or ones that can sustain a real and significant recovery, which are still undervalued.

This means that we are finding investment ideas in many different sectors, particularly in the quality end of the spectrum. The risks in the market have clearly increased, as many stocks are factoring in a recovery. If the market does see a round of profit-taking or a disappointing series of economic data, it is likely that the higher-quality stocks that have lagged recently will protect returns. On the other hand, if the market continues its positive momentum, we think that performance should broaden out.

At the sector and industry level, we favor consumer services, as a large number of firms in this sector have displayed cash-generative and resilient business models. We also favor health care—where, in our view, the ongoing strength of revenues is still not reflected in current valuations and cash flows have largely been underestimated. Within financials, our preference is for insurance, as the current prices are not reflecting the revenue capabilities of the leading European insurers. Meanwhile, we are currently underweight utility companies, as we believe the decline in the financial productivity of many companies in this sector is not yet reflected in their share prices; we have also incrementally lowered our exposure to industrials stocks.

The recent increase in market returns has been much more focused on the riskiest and most cyclical end of the market, causing some stocks to become fully valued, in our opinion. However, we think there still remains a great deal of value to be found across the market, particularly among higher-quality stocks. We favor companies that have compelling valuations and display strong characteristics, such as increasing market leadership in their fields, technological advantages, and improving financial productivity. Ultimately, we believe these are the stocks that will lead the market going forward.

Written by:
Aaron Barnfather, Director, Portfolio Manager/Analyst

JAPANESE EQUITY

From a “V” to a “U?”

With the general election out of the way, Japan welcomed its new prime minister to the leadership of the world’s second-largest economy. The Democratic Party of Japan (DPJ) has come to office with a manifesto designed to please everyone, save the vested interests that kept the Liberal Democratic Party (LDP) in power these last 50 years. How they will actually govern, which parts of the manifesto can legitimately be pursued, and which parts were electioneering fluff will go some way toward defining the future of what role Japan will play on the world stage. However, it is unclear whether the DPJ or their current policy focus is sufficiently differentiated from the construct of the party, which includes the former Socialist Party of Japan and disenfranchised LDP members, to be called a vision of the future. We think that it is more likely that this election marked the start of a multi-year process, which may lead to a more profound political realignment along isolationist and internationalist lines.

Meanwhile, the market has begun to look beyond the first-half production recovery. End-demand in those sectors that do not have the financial backing of a government incentive, be they Chinese intermediate goods production or American private consumption, looks to be anemic at best. Auto sales after the expiration of the American cash-for-clunkers program fell right back to the levels seen earlier this year. More worrisome for the Japanese auto companies is the phenomenal success of Korea. Hyundai is now the second-largest seller of small autos in the United States with a 19% share, double the level of one year ago. Time and again, American consumers have shown that they lack brand loyalty when a product of similar quality can be found for lower prices. Hence, Wal-Mart now advertises flat panel television sales, with Samsung and Vizio among the top three brands available. If Korea is the new “in,” this is decidedly bad news for the domestic Japanese production base. Japan still produces 10 million automobiles domestically and only consumes four million. Exports have to go somewhere, and without the U.S. market, it is unclear where they will go.

In a sense, the reality of excess domestic production capacity is the last facet of the “Japan, Inc.” model left to unwind. The financial structure that supported the funneling of low-cost capital to exporters was badly undermined by Japan’s real estate bubble and subsequent collapse. However, the exporters were given a reprieve from a painful restructuring of their domestic excess production model by the boom in consumption in America. This, in turn, was fueled by America’s own real estate bubble. The collapse in U.S. asset prices, and consequently private consumption, has now laid bare the foundation that underpinned Japan’s export success. The export sector and, most specifically, the auto companies now face a multi-year period of production cutbacks and plant closures before any form of normality can be restored to profits. As there have been no domestic auto plant closures in Japan’s history, this is not likely to be a well-received development.

As for the second half, earnings are likely to disappoint. Most companies profiled a relatively conservative first-half forecast, which they beat, followed by a significant “V”-shaped second-half recovery. Without fiscal-stimulus-supported consumption, demand is likely to return to trend line, and the “V” will look more like a “U,” or even an “L.” This has yet to be priced into expectations. In addition, domestic consumption remains focused on low-priced goods with the likes of discounters Shimamura and Fast Retailing enjoying robust sales at the expense of pretty much everyone else. We believe the DPJ needs to act fairly swiftly to forestall a renewed downturn; while their comments are supportive, the reality of the time it will take to execute makes the probability they can stop the slowdown soon remote.

Written by:
Timothy Griffen, Director, Portfolio Manager/Analyst

EMERGING MARKETS EQUITY

Optimistic in the Medium and Long Term

Emerging markets equities continued their impressive recovery in the third quarter of 2009, as credit and global equity markets, as well as investor sentiment, showed significant signs of improvement. Remarkably, every sector and every country but Morocco rose over the quarter, while stable prices continued in many commodities, and crude oil remained around $70 per barrel.

Relative to the MSCI Emerging Markets Index, we presently have higher exposure to countries such as Brazil, Mexico, Indonesia, Egypt, Turkey, and South Africa, and lower exposure to China, as we believe valuations in companies in those emerging markets, compared to their level of profitability, are more attractive than those of Chinese firms. On a headline P/E basis, China's market does not appear to be exorbitantly expensive relative to the rest of the emerging markets. However, China's large exposure to the financials sector skews the headline valuation, which we believe makes it appear cheaper than it actually is. When comparing across sectors within emerging markets, as we do, it becomes clear that Chinese companies trade at premiums and often have either similar or lower profitability versus their sector peers elsewhere among the emerging markets.

Also, while it is true that China has consistently grown faster than most of its global peers over the past 10 years, the best-performing markets during that period have been countries with much slower growth rates, like Brazil, Egypt, Russia, India, and Mexico.[4]

Nevertheless, it is important to stress that we have a positive view on China's macroeconomic outlook. Indeed, we see the Chinese economy as crucial at this moment, given that it is still growing while much of the rest of the world economy is contracting. However, it is not only China that benefits from strong Chinese growth. The positive impact is global, affecting certain countries and sectors more than others. Cognizant of that, we are analyzing the impact of China's strong domestic growth on domestic companies as well as on foreign companies in other emerging markets. For example, we see companies like Kumba Iron Ore, a South African iron producer, First Quantum Minerals, a Canadian copper mining company active in Congo and Zambia, and Grupo Mexico, a Mexican mining company, benefiting from the increased demand for metals deriving from Chinese economic strength. Similarly, we see companies like Hon Hai Precision Industry, a Taiwanese electronic components manufacturer, HTC, a Taiwanese producer of smartphones and mobile computers, and Oriflame Cosmetics, a Swedish direct-sales cosmetics company active in emerging markets, benefiting from China's low-cost manufacturing base.

At the sector level, given the large rises in the more economically sensitive sectors like materials and energy, we find higher value in more defensive areas, such as consumer-related sectors and telecom services.

We remain reasonably optimistic about emerging markets in the medium and long term, but are concerned, and therefore neutral, in the short term. Valuations have increased considerably due to a dramatic change in investor attitudes—from deeply bearish six to nine months ago, when we were bullish about the outlook, to widely enthusiastic now. We would therefore advise investors not to be aggressive at this time.

Written by:
James Donald, Managing Director, Portfolio Manager/Analyst

NOTES:

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1 Lazard Insights Conference Call Series, "Buy or Beware? Investing at the Crossroads," 17 August 2009, available at http://www.lazardnet.com/lam/global/calls.html

2 As of 9 September 2009. Source: Bloomberg and Moody's

3 Source: www.recovery.gov

4 Source: MSCI Emerging Markets Index

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