

July 2011

Outlook on the **United States**

The cross-currents in global markets continued to capture our attention through much of the second quarter and are likely to continue to do so in the third quarter. As the U.S. continues deleveraging and as re-regulation progresses, we continue to see widening divergences in economic conditions for a range of Americans. As we seek to capitalize on opportunities in the market, one key area of research for us is the evolution of the American labor market and the implications for overall economic growth, as well as the potential for inflation and growth prospects across a broad array of companies struggling to adapt to changing consumption patterns.

In this outlook, we will recap the past quarter along with several key topics we will be watching in the quarter ahead. Then, we will dig a bit deeper into the labor market and highlight some of our key findings and their investment implications.

The Past Quarter

During the second quarter, we once again experienced a period of elevated levels of macroeconomic uncertainty. Europe and China were ever present in the backdrop, even while events at home added to the concern that the recovery might be slowing.

1. European leaders continued to stumble from one deadline to the next in trying to strike some balance between what appeared to be a structurally flawed common currency and fiscal discipline amongst member states. As of the quarter-end, Greece was still in the spotlight. We believe the expectation for a resolution to the Greek crisis should be tempered and recognized for what it is, merely another credit extension until the overwhelming debt burden is restructured.
2. In emerging markets and China in particular, central bankers continued fighting their battle against inflation. China faces the added risk of what many consider to be a real estate bubble, inflated in part by massive economic stimulus during the crisis and the difficult process of sterilizing large inflows of dollars from sustained trade surpluses. Against this backdrop, investors are increasingly worried that the strongest engine pulling the global economic train might be at risk of a hard landing.
3. At quarter-end, the Federal Reserve officially ended QE2 and moved to a neutral position, as it related to security purchases. While we continue to believe QE3 might be in our future in 2012, we see the cessation of net new purchases as a good test of how debt markets handle a decrease in central bank demand. It is important to recognize that the Fed will continue to reinvest proceeds from maturing securities and hence is in neutral, rather than in a tightening mode.
4. To date, Congress has failed to negotiate an increase in the national debt limit and seems to be playing an increasingly dangerous game of brinkmanship with the national credit rating.
5. Unexpected intervention in the oil markets: Near the end of the quarter, the U.S. and International Energy Agency (IEA) surprised energy markets by announcing the release of 60 million barrels of oil from national strategic reserves. While the amount is not substantial relative to global demand, it clearly moved the psychology of the markets in the short term and gave consumers a breather from ever higher fuel prices globally.
6. Housing prices reached a new low. As we expected, home prices as measured by the S&P/Case-Shiller 20 city price index fell to a new low this quarter.¹ Unlike in the past, we are no longer as alarmed by the price index, as long as further declines are in the 5-10% range. The logic is that the pool of people who were prone to default strategically (e.g., by choice) has largely been depleted unless we see a much more substantial decline.

The Quarter Ahead of Us

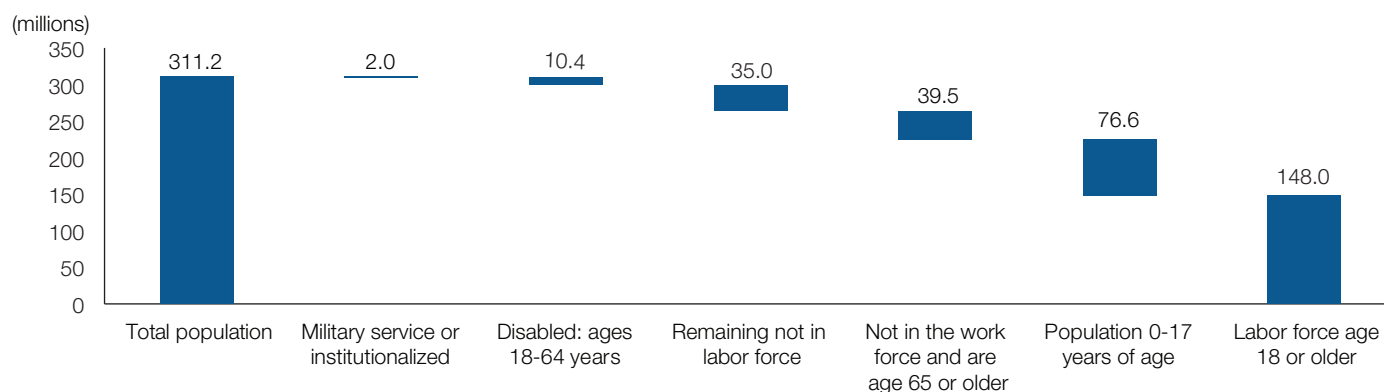
1. Europe is likely to continue muddling through the sovereign debt crisis. In the weeks ahead, there will be a host of pivotal dates to watch, ranging from decisions in Greece to any potential after effects of what we feel can only be described as a “debt default in disguise.” We do not expect a cataclysmic series of events, but we worry that investors are complacent regarding the potential spillover effects of a default or a series of defaults in Europe. For example, Spain is not in the clear in our view and would challenge any level of complacency among investors. The implications of the crisis escalating are meaningful for the U.S. since the EU is the single biggest export market for U.S. goods and services. Moreover, the financial systems of Europe and the U.S. are inextricably linked and would be in the spotlight again if Spain is the focal point.
2. U.S. debt ceiling and deficits: The most likely scenario from our perspective is that the Democrats will capitulate to the Republican demands of no new taxes and agree to a scaled back deficit reduction package in exchange for a hike in the debt ceiling. While we do not have as much visibility as we would like, based on our recent conversations with key policymakers in Washington, we would not be surprised to see a package of \$1-2 trillion of spending reductions over a 10-year period with no revenue increases.
To the extent our base case expectation is incorrect, we worry that the partisan brinkmanship under way is increasingly dangerous. In particular, we worry that one or more credit rating agencies might decide to get ahead of its peers and downgrade the U.S. from its AAA-rating. While the downgrade in and of itself would not be so meaningful, we fear that the implications for consumer and business sentiment would be quite negative, especially against the backdrop of a lethargic recovery and a lack of confidence in government in general.
3. Emerging markets inflation might be near a peak and tightening near an end: While this call is potentially a bit early, there is increasing evidence that year-over-year increases in prices in a number of key emerging markets are nearing a peak. To the extent that we begin to see a reduction in inflation rates, we would be less concerned over a hard landing in countries such as China.
4. More clarity on financial sector regulations: We are gradually gaining more clarity on how the re-regulation of U.S. and global financial institutions will play out. Since we have recently received the consultation package for Basel III capital requirements, we are now able to learn more about the rules of the road for banks and other financial intermediation companies. While one might expect clarity to be a positive for some financial stocks, the market reaction may well be more muted than expected or even negative as investors’ fears of more stringent regulation are confirmed.
5. State and local governments continue shedding jobs: Even while we navigate the federal debt situation, state and local governments are likely to continue to reduce spending. While these cuts might sound like a positive step, it is important to note that spending cuts typically mean less money transferred to the lowest income households, which generally have the highest propensity to spend such funds. Moreover, lower state spending also often means less investment in education, a catalyst for long-term productivity. We see these budget cuts as necessary, but negative for consumption growth.
6. U.S. house prices rebound seasonally before turning back down: We expect the recent Case-Shiller/20 city home price index rebound (seasonally unadjusted) to be sustained for a few months as buyers emerge from their winter hibernation and move during the spring and summer months. However, we would caution against any excessive enthusiasm unless we see a material decrease in unemployment. After the summer season ends, unless we have significant job growth, we worry about another 5-10% leg down in prices.

Jobs – The Key to Sustained Economic Growth

We believe that underlying much of the economic malaise is the stubborn unemployment problem. For example, resolution of the seemingly intractable housing problem rests largely on improvement in the labor market. Moreover, in an economy in which consumption comprises approximately 70% of all activity, employment is the pivotal variable that will drive growth. To the extent people are not employed, we also can draw conclusions about government fiscal conditions and even long-term socioeconomic and sociopolitical trends. Last, labor is likely the key determinant of whether inflation becomes problematic, as labor comprises 65-70% of the cost of goods sold in the United States. Given how important labor is to the macroeconomic and political environment in which companies operate, we felt it was important to dig deeper and ensure that we understand how changes in the labor market might affect the revenue and expenses of companies in which we might invest.

To assess how a changing labor situation might affect companies in the U.S., we focus on two specific data sets related to the population and labor markets. First, we review the composition of the U.S. population as of May 31, 2011 (U.S. Census Bureau estimate). From that total

Exhibit 1: Who Is in the Labor Pool?



As of May 31, 2011

Source: Bureau of Labor Statistics, U.S. Census Bureau, LAM estimates

picture of the population, we look at different age groups to redefine the employment force. Second, we examine the very different picture seen through the lens of employment by educational attainment.

At the aggregate level, we are reasonably confident that the U.S. does not face much risk of a labor price spiral. Specifically, we believe that the underutilization of human capital in the U.S. is far worse than many people realize. In fact, only 59.8% of the Americans 18 or older were working as of May 2011. If we exclude all Americans age 65 and over, only 68.6% of citizens age 18-64 are employed.²

What becomes apparent from Exhibit 1 is how many people are not considered part of the labor pool. The ultimate point is that above and beyond the millions of people who are officially unemployed, discouraged, or underemployed, there are millions more who are employable but 65 years or older in age, disabled in some way (but in many cases still capable of adding economic value) and in other cases simply “not in the labor force.”

Clearly there are Americans who choose not to work, but are employable if they were to re-enter the labor market. Even if we try to remove these people who are not employed by choice from our analysis, there is also reason to believe a large number of the people who are no longer in the labor force per Bureau of Labor Statistics (BLS) definitions are actually involuntarily unemployed.

Even under the most generous interpretation of the numbers, we view the underemployment rate as being 18.25% as of May (officially unemployed + discouraged workers + part-time workers who want full-time employment but cannot attain it for economic reasons). This figure contrasts with the BLS reported 15.4% underemployment figure, which excludes over four million people who are identified as currently wanting a job. Based on this analysis, we would tend to discount the risk of a wage-price inflation spiral in the U.S.

However, if we examine the labor market through a different lens, we could reach a different conclusion. We have talked about a theme of widening divergences and this approach lends more credence to our concern over disparate outcomes. Assessing the population based on educational attainment, in our view, yields a very different picture of the employment situation and potential for wage pressures.

As we have noted, when the BLS reports the unemployment rate, it only includes people who are considered part of the labor force. The people who are not part of the labor force may be categorized as such for a wide range of reasons, some of which were illustrated in Exhibit 1. Beyond those factors, however, we have little transparency. When we look at employment by educational attainment, it becomes more evident that a significant portion of the potential labor force in the U.S. has simply quit trying.

For example, as shown in Exhibit 2, only 46% of Americans without a high school diploma are even counted in the labor force. If we assume that a large share of these people are older and hence were less likely to finish high school, the figure is a little less shocking, but is high nonetheless. Perhaps the most representative figures of what full employment looks like are those for the people with a bachelor’s degree and higher. In this case, 77.2% of people are in the labor force.

In Exhibit 3, only 4.3% of that same set of the population are not working and the resulting employment-participation ratio is 73.9% (77.2% * (1-4.3%)) as shown in Exhibit 4. If we assume that people in the most highly educated cohort have the most flexibility to choose not to work, we can perhaps get a better sense of how bad the employment situation is for the rest of the country.

Employment by Educational Attainment

Exhibit 2: Labor Participation Rate

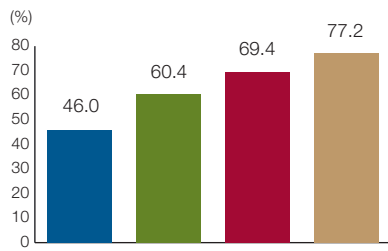


Exhibit 3: Unemployment Rate

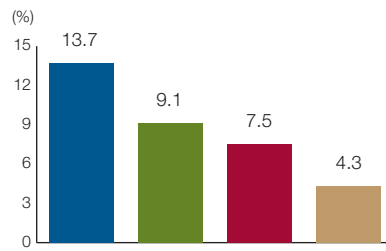
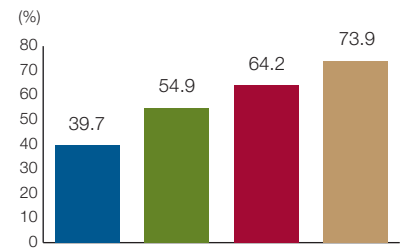


Exhibit 4: Percentage of Population Employed



■ Less than a high school diploma ■ High school graduates, no college ■ Some college or associates degree ■ Bachelor's degree and higher

As of May 2011

Source: Bureau of Labor Statistics, U.S. Census Bureau, LAM estimates

Put another way, at the lowest levels of educational attainment, people have the lowest earnings, and hence less flexibility to choose not to work. The figures, however, would seem to indicate exactly the opposite, understating the true level of unemployment by a large degree as a result.

If we think about the implications of these employment rates, we can see that we may face a future in which the most highly educated employees enjoy sustained wage increases while the rest of the country finds itself trapped in situations where wage increases are tough to achieve and yet costs increase for basic consumer staples. This would be the epitome of our theme of widening divergences.

Investment Implications

From a long-term perspective, we see the unemployment situation as perhaps the single most important problem facing the U.S. economy. A country cannot sustain itself on the labor and tax revenue of only 60% of its adults. In most cases, the unemployed not only do not contribute to the tax collections, but they instead draw their income from that pool. We see the widening gaps in economic conditions for different parts of the population as feeding into not only the inflation discussion but even into topics such as the debt ceiling and the direction the country will take politically. We continue to believe the employment situation will lead to increasing opposition to free trade in the long-run and could sharpen the partisan divide as people seek easy solutions to increasingly complex reasons for their individual situations. To the extent we fail to educate and train our citizens to be competitive in a global work force, the burden will only continue to increase on the rest of society. At the same time, the unemployed will continue to endure a life of trying to merely get by and not enjoying the satisfaction of being a productive member of society.

At the company and the investment level, we have seen commodity prices increase substantially over the last year. During that time, we have carefully examined which companies might be particularly susceptible to such cost pressures. Fortunately for many of these companies such as retailers, they faced cost pressure only from commodities, but not from their labor force given elevated unemployment levels. As we move forward, we will pay close attention to the evolution of employment and unemployment rates in different parts of the population to ensure our scenario analysis for each company incorporates the best possible assumptions regarding the cost of goods sold and implications for profitability. Michael Dell recently gave an interesting interview on CNBC. In the discussion, he indicated that hiring highly qualified technical employees is very difficult as there are too few such people available. He went on to say that less skilled jobs are an entirely different story and that opportunities to work in a distribution center or other less technical role inevitably generate a flood of applications. Clearly we need to assess potential skills shortages for some companies and the resulting cost pressures, while for other companies we hone in on the possibility that labor prices might even decline.

Beyond expenses, depending on which part of society a company sells its products and services to, we might find upsides or downsides to revenue potential depending on job formation trends. Following on from the Dell example, if highly paid employees are in demand while less skilled labor is in surplus, the revenue implications for a luxury retailer versus a mid-tier retailer could be starkly different.

At this point, it appears premature to ring the alarms regarding the potential for a broad-based wage-price spiral and for corporate profit margins to be hit in aggregate as a result. That said, we continue to focus on the companies with the most operational flexibility to adjust to such an environment were it to occur. Moreover, if we were to move into a more inflationary environment, we believe that the companies with the strongest balance sheets and cash flow would be able to handle the macroeconomic transition most easily as they would earn incremental income on their net cash, face less pressure from increased interest rates on their debt, and be positioned to capitalize on the pain felt by competitors in an inferior financial position.

Notes

- 1 The S&P/Case-Shiller 20 city price index is published monthly and measures the change in price for repeat sales of the same single-family homes in a specific city.
- 2 Source: Bureau of Labor Statistics, U.S. Census Bureau, LAM estimates

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Published on July 8, 2011.

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