

October 2011

Outlook on the **United States**

Macroeconomic and political forces continued to drive market volatility in the third quarter and, in our view, are likely to do so for some time to come. The United States and countries within Europe continue to grapple with the hangover associated with years of excessive borrowing by governments and the private sector. While each of these countries has unique circumstances, they all likely have years of deleveraging ahead. Given the fragility of the economic recovery to date, regulatory tightening has paused briefly. However, we anticipate that the longer-term reversal of decades of deregulation will be difficult to avoid. Amid deleveraging and re-regulation, we continue to expect widening gaps between wealthy and middle-income households; well educated and less educated individuals; the elderly and the young; and, increasingly, between governments and their citizens. These gaps encompass diverging economic, political, and social objectives and priorities.

During the second-quarter earnings season, the S&P 500 Index, excluding financials, delivered revenue growth of 13.2% and earnings-per-share growth of 18.2%. Importantly, approximately 75% of companies in the index reported surprisingly positive earnings, while more than 70% reported higher-than-expected revenue. In spite of this strong showing, U.S. equity markets declined 12.4% over the quarter.¹

Our analysis suggests that the disconnect between corporate results and the value of their shares can be primarily attributed to three drivers:

1. The political turmoil surrounding the U.S. debt ceiling increase in early August and the subsequent long-term credit rating downgrade by Standard & Poor's

Unfortunately, the series of events around the debt ceiling debate merely added to the negative consumer and business psychology in the United States as it reaffirmed the perception among many that the government is either unwilling or unable to address the key issues facing the country.

2. Ongoing turmoil in the Eurozone

Europe continued the painful process of trying to address the fiscal challenges in its periphery and, more importantly, in Italy and Spain. Italy was of particular concern to investors in the third quarter, as yields spiked and the European Central Bank (ECB) was forced to step in and use the Securities Markets Program (SMP) to buy Italian and Spanish bonds for the first time in this crisis. The SMP purchases were effective to some degree but, by quarter-end, Italian interest rates were creeping back toward the 6% level that many investors deem unsustainable.

3. Uncertainty regarding the risk of an industrial slowdown in emerging markets

During the quarter, Purchasing Manager's Index (PMI) readings from virtually all regions globally decelerated to levels approximating 50. The reading from China, however, was disconcerting, since it was largely misinterpreted. In the United States, a PMI reading of 50 is generally considered to represent the line between manufacturing growth and stagnation. In China's case, that value corresponds to industrial production growth of 13% year over year. While we would not be surprised to see economic growth moderate in the emerging markets, we do not currently expect a severe slowdown in the Chinese industrial economy at this point.

Beyond these three drivers of volatility, not all news was negative. Housing prices in the United States continued their seasonal advance, increasing by 3.7% from January through March (winter is the slowest season for home sales and prices). Seasonally-adjusted numbers were relatively stable, increasing only 24 basis points from the period January through March versus May through July 2011.²

The U.S. Federal Reserve (the Fed) has begun "Operation Twist." In line with this program, the Fed has indicated that by June 2012, it will sell \$400 billion worth of Treasury bonds with maturities of less than three years and use the proceeds to buy a like amount of bonds

with maturities between 6 years to thirty years. Upon completion of the program, the average maturity of the Fed's Treasury securities portfolio will increase from 75 months to 100 months.³

Operation Twist aims to reduce long-term financing costs and inject some life into the housing market. It is worth noting that the average cost of a conforming 30-year fixed rate mortgage in the United States has declined to a multi-decade low of just over 4.0% as of quarter end, while the jumbo mortgage rate for a 30-year loan has declined to only 4.6%.⁴ In spite of these low rates, we have yet to see a major increase in homebuyer applications for mortgages. The Mortgage Bankers Association (MBA) Purchase Application Index continues to hover near 15-year lows. The MBA Refinancing Index, however, has increased substantially, indicating that homeowners who still have positive equity in their homes should be able to reduce their carrying costs, and either deleverage more rapidly or consume more. Sadly, any economic gain enjoyed by borrowers is equally offset by pain for lenders, who receive lower interest payments.

Looking ahead, investor focus in the fourth quarter is likely to be similar to that in the third quarter. Here, we have identified three major areas of investor interest:

1. Eurozone fiscal challenges

In early October, the remaining Eurozone member nations are expected to vote on approving the European Financial Stability Facility (EFSF) as a mechanism for addressing fiscal pressures. Approval of the EFSF is not, in and of itself, a solution to the Eurozone's problems. The challenge for the Eurozone is the events themselves and the sequence in which they occur, as we believe that this is pivotal to the outcome. For example, if Greece were to default after a forced bank recapitalization program across the Eurozone, it could be much less dangerous than a Greek default in the absence of major bank recapitalization. We see many variables that could change the outcome of the European crisis and continue to assess potential scenarios that could occur and how those events might affect our investment choices.

2. U.S. budget decisions

The United States government has designated a Joint Select Committee, or "Super Committee," that is held to a series of tight deadlines. In the absence of meaningful progress, automatic spending cuts totaling \$1.2 trillion will be implemented, with half of the reductions affecting defense spending and the other half affecting discretionary spending. The committee comprises six senators and six congressmen. None of the six senators is up for re-election in 2012, which we believe will lessen potential pressure on them to make politically-driven decisions. On the other hand, bipartisanship appears to be lacking, as the final week of the quarter included a near-shutdown of the government due to disagreement in Congress about allocation of disaster aid through the Federal Emergency Management Agency (FEMA). While the dispute was ultimately resolved, the fact that Congress was on the brink of allowing a shutdown again over 0.1% of the federal budget does not bode well for a spirit of compromise and problem-solving, in our view.

Milestone dates for the Joint Select Committee:

October 14: Deadline for House and Senate Committees to submit recommendations to Joint Select Committee

November 23: Deadline for Joint Select Committee to develop a plan to cut federal deficits by at least \$1.5 trillion over 10 years

December 23: Deadline for Congress to approve recommendation from Joint Select Committee

January 1: To the extent Congress has not passed cuts totaling \$1.2 trillion, automatic cuts will be imposed to ensure a minimum reduction of \$1.2 trillion in deficits over 10 years. If Congress has agreed to any reductions, the automatic reductions will be the difference between the agreed reductions and the mandated \$1.2 trillion in savings. The mandated automatic cuts would comprise equal reductions in defense and non-defense spending, which includes a 2% cut in payments to Medicare providers.

3. Emerging markets' attempt to achieve a soft landing

Given the recent swoon in shares of companies in the industrial and materials sectors, we are keenly aware of any signs that the emerging markets have achieved a soft landing and succeeded in fighting inflation. If we see stabilization or resurgence in industrial indicators from China and other emerging markets, it could positively affect our views of these stocks.

As we navigate the macroeconomic and political uncertainty, we remain committed to our focus on identifying companies that can protect their franchises and capitalize on opportunities in their markets. These companies typically have strong balance sheets, robust organic cash flows and operational flexibility. In spite of our disciplined approach to investing in companies with high financial productivity relative to their current share prices, we have been frustrated by the degree to which operational differentiation among companies has not been reflected to date.

Toward the end of the quarter we began to see a divergence in the performance of what we consider higher-quality companies, relative to their peers. Ideally, we would like to see that trend persist; but the reality is that investors generally tend to be less discriminating during

periods of elevated macroeconomic and political instability. Over the long-run, however, we believe that share price performance will ultimately reflect underlying cash flows, as well as the capital-utilization decisions by management teams.

Looking forward, we expect two possible market outcomes: either substantial upside (if sovereign credit problems are resolved satisfactorily) or substantial downside (if the macroeconomy is upended by fiscal challenges). While we do not have clarity on when these macro questions will be resolved, we believe that investors will ultimately seek opportunities to invest in companies with strong fundamentals, as well as firms that do not rely on substantial leverage to generate return.

We continue to believe that the companies in which we invest are positioned to deliver on their specific fundamentals and cash flows.

Notes

- 1 Source: Standard and Poor's and Bloomberg, September 30, 2011
- 2 Source: Standard & Poor's Case Shiller
- 3 Source: The U.S. Federal Reserve
- 4 Source: Bloomberg and BanxQuote. Conforming mortgages comply with loan specifications that can be guaranteed by Fannie Mae, Freddie Mac, or other government agencies. These loans have a limit of up to \$729,750 until September 30. As of October 1, the limit in the costliest cities declined to \$625,500, while much of the rest of the country was subject to limits approximating \$417,000. The other key criteria is that a buyer have 20% home equity (i.e., a loan-to-value of less than or equal to 80%).

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