

January 2012

Outlook on the United States

In 2011, U.S. companies delivered strong results notwithstanding a challenging macroeconomic environment. Despite regaining pre-crisis revenue levels and recording earnings per share growth in excess of 10% year-over-year for eight consecutive quarters, the total return on the S&P 500 Index was a paltry 2.1%, including dividends, or -0.003%, in price terms.¹ While these returns are nothing to cheer about, it is worth noting that the U.S. stock market was the best-performing major equity market globally and, in our view, still has room to deliver strong returns going forward on both a relative and an absolute basis.

Unfortunately, in 2012 we expect a likely repeat of the same macro considerations that overwhelmed the micro in 2011. We continue to believe that over time, investors will reward companies that grow revenue and earnings. Beyond simply paying more for headline growth, at some point we believe investors will also appropriately reward the companies that generate high levels of return on capital through the cycle, including during the worst economic downturn since the Great Depression. While it might be premature to expect multiple expansion at this juncture, we anticipate that multiple compression should cease.

We believe that a range of key macroeconomic, political, and regulatory topics will be important drivers of investment returns in 2012. In evaluating these drivers, we take a more geographically expansive view than usual, reflecting the interconnectedness of global markets. We will begin by looking back on 2011 for the key lessons learned and move on to review the key long-term themes affecting the United States and other developed markets at the start of 2012. Finally, we discuss our base case expectations for events in 2012 and the associated investment implications.

The Year in Review

One could describe 2011 as a year of putting out fires globally, with varying degrees of success. Fortunately, Ben Bernanke and his colleagues at the U.S. Federal Reserve (the Fed) are students of the history of financial crises and have thus far successfully maintained liquidity in the financial system. Throughout 2011, U.S. authorities deployed every available fiscal and monetary tool to douse the flames of the Great Recession, whose embers still have the potential to ignite and transform into deflation or even a depression. One could argue that the Fed is running low on incremental tools at its disposal at precisely the time when fiscal tools are being taken off the table.

Across the Atlantic, we see a somewhat similar situation. The primary difference between the United States and Europe is that a great deal of uncertainty results from a lack of historical precedent and procedures. Effectively, European leaders are still working to determine who is responsible for solving the structural, fiscal, and monetary problems facing the European Union.

Leaders in a number of emerging market countries faced a different challenge in 2011, as they sought to decrease the rate of inflation triggered by a combination of rapid economic growth in prior years and the efforts of the Fed and other developed market central banks to flood their economies with liquidity, which subsequently added upward pressure on commodity prices. It appears that a number of countries have won the fight against inflation, at least for now. We believe the key remaining risk is the steepness of the decline in growth for these economies.

Delving deeper, however, lessons from 2011 will likely prove instructive in 2012:

1. **Economies:** Developed economies demonstrated the difficulty of recovering from a financial crisis. Given the unprecedented debt levels of the United States, Europe, and Japan at the start of the Great Recession, many investors began to realize that we are poised for years of deleveraging. We believe the private sector will likely continue to decrease debt, followed by the public sector in the next several years. Historically, in a recession, government deficits have almost always increased substantially. After a recession, deficits would decline, but

would rarely move into a surplus position. In fact, the common rule of thumb was that a *deficit*-to-GDP ratio of 3% or less was viewed as acceptable, as it implied a stable or declining *debt*-to-GDP level. At this point, the amount of debt outstanding is so high that the interest alone makes it difficult to grow GDP fast enough to reduce the debt-to-GDP ratio. In other words, it is difficult for growth in GDP (the denominator) to outpace that of debt (the numerator) sufficiently to reduce the ratio to a safe level without running budget surpluses and paying off existing debt.

2. **Society:** Sustained economic stress can lead to fractures within a society and decrease its ability to address the underlying causes of the problem. Elevated debt levels compound this societal stress as the fear of loss of savings pits savers against borrowers, for example. These stresses, combined with widening gaps in economic, social, and political terms within a society, can be dangerous given the need for a shared sense of national purpose, particularly during a severe economic downturn.
3. **Governments:** Governments are a mirror of their society. Fractiousness in the population can further aggravate the challenges facing a democratic government, especially one that relies on campaign contributions from the most fervent partisans. In spite of the recent challenges to the prospect of increased regulation, particularly for the financial industry, the natural and appropriate instinct of regulators and elected officials in the aftermath of a financial and economic crisis is to institute mechanisms to prevent a recurrence of a similar crisis. In 2011, it was clear that even companies in dire straits that had been rescued by the government would resist further restrictions on the behavior that had contributed to their own near demise.
4. **Markets:** Investors were reminded that there is no such thing as a risk-free investment, as even purportedly rational people can choose to do irrational things. One need look no further than Washington D.C. in early August for instances of irrational behavior from political leaders relative to financial and market-related issues, in our view. The challenge of assessing the intersection of economics and politics was compounded by the manner in which markets reacted in August to U.S. budget deficit issues, which may have fueled a sense of complacency among political decision makers about the potential catastrophic implications of a decision they might be asked to make again in the years ahead. Ironically, while some groups in the United States promoted the idea of a default, we believe European leaders expended substantial energy and rhetoric in maintaining the façade that one of their own states was not in default, even as lenders were asked to take a so-called voluntary write-down on their bonds.

Long-Term and Secular Themes

In our view, the United States and much of the developed world face three primary long-term trends:

1. **Deleveraging:** In the Fed's most recent release in mid-December, the Flow of Funds report indicated that U.S. debt peaked at a higher level than previously reported. The Fed switched its data source for the amount of municipal debt outstanding and, in the process, found that there was approximately \$740 billion more of such debt since 2004, largely held by households. This increase raised the peak U.S. debt-to-GDP ratio (as of first quarter 2009) to 373.4%, as shown in Exhibit 1.² This ratio has since declined to 339.8%, but still has a long way to go to reach sustainable levels, in our view.

Exhibit 1 U.S. Debt by Category

	2009 Q1		2011 Q3		2009 Q1 vs. 2011 Q3
	(\$ trillion)	(% of GDP)	(\$ trillion)	(% of GDP)	(change in % of GDP, in basis points)
Total Debt	51.9	373.4	51.6	339.8	-3360
Government Debt	9.7	69.5	13.1	86.5	+1700
Financial Debt	17.0	122.6	13.7	90.5	-3210
Consumer Debt	13.8	99.0	13.2	87.0	-1200
Corporate Debt	11.4	82.2	11.5	75.7	-650
GDP*	13.9	—	15.2	—	—

*Annualized

As of December 31, 2011

Government debt is the sum of federal, state, and local debt.

Source: U.S. Federal Reserve, Bloomberg, U.S. Treasury Department

2. **Re-regulation:** Most of the significant legislation occurred in 2009 and 2010, with the passage of health-care reform and the Dodd-Frank financial regulatory reform packages. The overhaul of the U.S. health-care and financial systems accelerated somewhat in 2011 with the most notable proposals issued by the Fed and other regulators regarding proprietary trading and securitization. The Consumer Financial Protection Bureau (CFPB) also began issuing guidance on disclosure rules and played a relatively benign role. Beyond Washington, the Basel Committee on Banking Supervision continued to develop the rules meant to apply to the global financial system under Basel III.

There were efforts in the United States to de-fang the Dodd-Frank legislation in particular as some politicians blocked appointees to new regulatory bodies and/or funding for incremental regulators. While these efforts succeeded in slowing implementation, we continue to view an outright repeal of the Dodd-Frank legislation as highly unlikely, even if the Republican Party controls Congress and the White House. We believe that health-care reform legislation would be a much more important target in such a scenario.

3. **Widening gaps:** In early 2011, we suggested that a key long-term trend was the widening divergences in society based on education, age, and employment. Our view continues to be that these gaps will lead to major political and regulatory shifts over time. In 2011, this process began to manifest itself through the Tea Party and the Occupy Wall Street movements. These movements can be described as having, to some degree, roots in a sense of relative deprivation and/or recognition of the degree to which various segments of society are either enjoying or enduring vastly different financial conditions. Many people may not view the Tea Party in this manner, but we believe that the Tea Party is an example of how economic and social stresses, as described above, have begun to influence the realm of government, based on concerns over how the fiscal response to the Great Recession might develop in the long term.

What to Watch in 2012

While it is wishful thinking that turning the page on a calendar changes the environment, the reality is that little has changed in the New Year. The key elements of uncertainty for 2012 are likely to remain much the same in the United States and Europe as in 2011.

The key elements we are monitoring in the United States in 2012 are:

1. **Sustained, albeit lethargic, economic growth.** The United States exited 2011 with a slight tailwind from a range of indicators, including Institute for Supply Management and Purchasing Managers' Index manufacturing data, jobless claims, and the National Association of Home Builders Market Index. We expect U.S. growth in 2012 to be driven by a combination of factors, as listed below:
 - a. Population growth, which has averaged approximately 1% per annum over the past 20 years³
 - b. Pent up demand for labor and, ultimately, increased hiring—even if at a slow pace
 - c. A multiplier effect from pent up consumer demand for automobiles and housing as employment gradually improves
 - d. Increased exports to emerging markets, although export declines to the Eurozone could offset some of this growth
 - e. Regional differentiation, as agriculture and natural resource industries continue to drive growth in certain areas while housing and other types of overhang depress growth in other areas.
2. **The start of deficit reduction and plans for further improvement beyond 2012.** To some degree, deficit reduction is already built into current U.S. law, with our base case expectation being a decline in the deficit relative to GDP from 8.7% in fiscal year 2011 ending 9/30/2011 to 6%–6.5% of GDP in fiscal 2012. While the addition of another \$1 trillion to the U.S. federal debt is clearly not good news, the \$300 billion reduction from the prior year is substantial, and a good start, in our view.
3. **Elections.** Voters in the United States face a major philosophical choice in 2012, and will determine the country's direction. Unfortunately, the dialogue to date has been light on deep discussions about solutions to the country's problems and heavy on finger-pointing. After assessing national election scenarios, we continue to maintain a base case scenario in which President Obama is re-elected to a second term and the Republican Party adds on control of the Senate to its existing hold on the House of Representatives.

There is a case to be made that a divided government with a second-term President could be good for the country assuming the end result entails a balanced approach to dealing with both near-term and long-term fiscal issues. As we have previously noted, U.S. federal government spending relative to GDP is at levels not seen since World War II, yet taxes as a percentage of GDP are at levels approximating a 60-year low. We believe the answer to this budget gap cannot be as simple as cutting spending or raising taxes. Instead, it should be a combination of the two, and hopefully constructed in a way that encourages long-term productivity and growth. It is possible that a divided government could lead to that solution.

The potential for a clean-sweep Republican win (House, Senate, and Presidency) may appeal to some, but given the commitments made by almost every major Republican candidate to address the deficit solely through spending cuts, we are concerned that a fulfillment of these pledges would disrupt the already weak economic recovery by putting pressure on consumers. One could argue that, once in office, cooler heads will prevail and even a Republican President might raise taxes to reduce deficits. However, it appears the current candidates all realize that violating a “no new taxes” pledge could jeopardize their chances of re-election, reminiscent of the experience of former President George H.W. Bush.

Likewise, the potential for a clean-sweep Democratic win might appeal to others. Given the Democratic Party's reluctance thus far to engage forcefully in long-term entitlement issues and near-term spending challenges, we also find that this scenario lacks enduring appeal.

4. **Housing prices.** We expect house prices to continue to decline through the first half of the year, as measured by the S&P/Case-Shiller 20 City Home Price Index. We expect the downdraft to be primarily driven by seasonal factors (housing demand is weak in winter) and by continuing efforts to reduce the backlog of repossessed homes to be sold. We do not foresee a material increase in house prices at any point in 2012, but believe that we may see stabilization and some degree of increase in home construction. This increase is likely to be largely in the multi-family segment, as parts of the country move more toward renting and away from ownership. That said, we believe there is room for increased single-family production, as the aging supply of foreclosed homes no longer satisfies the needs of new buyers.
5. **Interest rate policy.** We continue to expect the Fed to maintain its accommodative monetary policy well beyond 2012, with near-zero interest rates for short-term funding and through extraordinary measures aimed at holding down long-term interest rates. The most likely cause of substantially higher long-term interest rates in the United States, in our view, would be very strong economic data from the United States and the Eurozone. While we believe the longer-term trend of deleveraging makes this less likely, nonetheless it is important to acknowledge the risk.
6. **A Supreme Court decision on the Patient Protection and Affordable Care Act.** The Supreme Court is expected to hear the case against the Affordable Care Act in March. The rulings from the Appellate Courts to date have been split with three of the four courts upholding the constitutionality of the law, and the fourth indicating that the requirement for every individual to purchase insurance is unconstitutional. This ruling could influence the election outcome and would certainly affect healthcare stocks.
7. **Geopolitical uncertainty.** It is a given that geopolitical volatility could derail the best forecast. In light of the increasingly audible saber rattling emanating from Iran, it is appropriate to note that any disruption to Persian Gulf oil flows, as one example, would very negatively affect our outlook. We are not forecasting actual military engagement. Rather, we see increasing risk that the brinkmanship related to Iran's nuclear program could lead to political upheaval there if economic sanctions are as severe as intended.

In the Eurozone, we see substantial sources of potential volatility, especially in the early part of 2012. While Eurozone exports account for less than 10% of the revenue generated by a typical company in the S&P 500,⁴ volatility in the region undoubtedly affects U.S. companies on the margin in the non-financial sector and more directly in the financials sector. The primary drivers of risk include:

1. **Italian debt refinancing requirements will peak from February to April at approximately €150 billion.** While we expect Italy to be able to refinance its debt, we are concerned about the interest rate that it will have to pay in order to roll over its debt.
2. **France may see its long-term credit rating downgraded from AAA.** This is not very meaningful from an economic point of view, but has substantial implications for the European Financial Stability Facility (EFSF), as the facility is designed to function with the backing of AAA-rated sovereigns. France's role is pivotal to the facility and there is no ready replacement for the EFSF, at least until July 2012, when the European Stability Mechanism (ESM) is expected to be in place.
3. **Spain could become the focal point of concern.** Year-end announcements that Spain's fiscal problems are substantially worse than previously expected, combined with an overwhelming unemployment problem could put Spain in the crosshairs of bond markets. Spain's fiscal position appears to be better than Italy's, but the aggregated Spanish economy is much more indebted to foreign creditors and Spanish households are much less able to cover the debt than Italy's.
4. **Greece's restructuring could become disorderly.** There is no guarantee that Greece can maneuver successfully across the tightrope of getting bondholders to accept larger "voluntary" losses to avoid having its bonds go into default. If Greece is declared in default by credit ratings agencies, the ECB cannot accept such bonds as collateral and credit default swaps would be triggered (independently of the ECB rules). We find it difficult to forecast how events might unfold in that case.
5. **Treaty changes and other plebiscites could derail Eurozone progress.** The EU summit meetings on December 8-9 ended with agreement to seek changes in each member nation's constitution (or an equivalent level of rules) to allow much deeper interference in national fiscal issues by Brussels. We are concerned that obtaining public support to relinquish national sovereignty across the Eurozone will be challenging. Given that we believe more fiscal union is necessary to sustain the monetary union, this is clearly a major concern.
6. **Austerity measures could be so severe that they push the entire Eurozone into a deep recession.** It is already largely accepted that the Eurozone is likely to suffer from GDP declines early in 2012. We worry that excessive cuts in government spending combined with sharp increases in taxes may push the Eurozone deeper into recession than many observers expect.

The United States and the Eurozone share a common problem in that both need time to deleverage successfully without pushing their economies back into recession. Unfortunately, in both cases, we believe there are likely to be ongoing increases in tensions in society as policy decisions highlight the differences in interests of the rich and the poor, savers and borrowers, as well as the old and the young.

Investment Implications

As always, we believe it is imperative to fully assess the susceptibility of companies to downside risk as well as upside reward potential. As we consider the litany of macroeconomic, political, and regulatory risks listed above, it should be clear that there is no such thing as a risk-free investment. In fact, we appear to be at a juncture where investors are once again seriously examining whether companies might be less risky than their home country governments in some cases. We would caution against views that are too extreme on that topic, as governments retain their ability to tax income and assets that are located within their borders (or beyond, in the case of the United States). That said, companies have performed impressively in 2011 in spite of a weak economic backdrop.

As we look to 2012 and beyond, we believe that an important lesson of 2011 is the ability of a company to grow even if real GDP is sluggish. Consider the hypothetical situation shown in Exhibit 2. The exhibit demonstrates that company revenue growth expectations should take into account real GDP, inflation, market share gains, and international growth. Taking all of these factors into consideration implies potential corporate revenue growth of 5%–11% even in a weak economic environment. If we also account for operating leverage and capital management, we can arrive at high single-digit to low double-digit earnings growth per share for listed companies.

Exhibit 2 Even in a Slow Growth Economy, Equities Can be Attractive

Real GDP	1–3%
Inflation	+2–3%
Market Share	+0–2%
International Growth	+2–3%
Total	5–11%

For illustrative purposes only.

In conclusion, we remain optimistic about the prospects for U.S. companies to deliver revenue and earnings growth in our base case scenario. We continue to find excellent investment opportunities, many of which are in companies that have been de-rated in 2011 in spite of great results. We believe these companies not only have excellent organic cash flow, strong balance sheets, and operational flexibility, but also have attractive valuations. In our view, these characteristics should enable these companies to persevere through volatility and be rewarded appropriately for their resilience when major macroeconomic, political, and regulatory concerns become less prominent in investors' minds.

Notes

- 1 Source: Bloomberg. As of December 31, 2011
- 2 U.S. debt-to-GDP includes all domestic debt incurred by households, corporations, financial companies, and governments
- 3 Source: Haver Analytics, U.S. Census Bureau. As of December 31, 2011
- 4 Source: Citigroup, New York Times. As of January 1, 2012

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