Outlook for Global Equity Markets

Global stocks rebounded strongly in March amid a growing sense of optimism due to signs of stabilization of the global financial system. The most recent rally, however, was unable to offset the sharp declines in January and February, and equity markets ended the first quarter of 2009 in negative territory. The outlook for the global economy still remains highly uncertain. A constant flow of poor economic data, including rising unemployment figures from the G-7 countries, called for concerted efforts by governments to forestall further deterioration of the economy. The United States, joined by the Bank of England and the Bank of Japan, initiated aggressive monetary measures in the form of quantitative easing. This surprising move by the U.S. Federal Reserve (the Fed) brought an immediate effect, as long-dated Treasury yields fell, market sentiment improved, and the prospects for economic recovery looked better.

We have seen unprecedented government action across the world over the last few months. Whilst it is clear, in the short term, that world GDP is still deteriorating, the desire of governments to put a floor under asset prices and slay the specter of deflation cannot be underestimated and therefore this sets up an interesting juxtaposition. While equities visibly look inexpensive, the outlook for corporate profits is still uncertain.

U.S. EQUITY

The Road to Recovery

As equity markets gyrated, the U.S. government announced a number of key policy initiatives in the first quarter that we believe should contribute meaningfully to stabilize the economy and financial system over time. While we are encouraged by this progress, we do not believe we are fully on the road to recovery yet. In particular, we are concerned that the policies announced to date to address home prices will do little to reduce the 22% to 27% decline we expect to see from the level observed at the end of January. In spite of this concern, we are seeing signs of a change in market psychology from what can be best characterized as panic to differentiation. In our opinion, this change in behavior bodes well for forward-looking investors who can benefit from identifying the winners and shunning the losers as we migrate toward recovery. We believe our focus on strong organic cash flow, solid balance sheets, market leadership positions, and operational flexibility is well suited both to the environment now and to what we expect to see when the economy regains its footing.

THE QUARTER BEHIND US

Through the year-to-date period, the U.S. government has transitioned from a policy stance best characterized as reactive and tactical to one that is more strategic and comprehensive. While some announcements were counterproductive to capital markets due to the lack of key details (which increased, rather than decreased, the level of uncertainty amongst investors), we think the actual substance of the policies should work to mitigate the downward pressure on economic output through 2009 and beyond. We believe that the most important achievements of the quarter were:

- Announcement of the Public-Private Investment Program (PPIP)
- Expansion of the Term Asset-Backed Securities Loan Facility (TALF)
- Passage of the fiscal stimulus package

The PPIP and TALF programs should meaningfully impact the financial system by initiating the process of removing toxic assets from the banks and shadow banking system, while also facilitating funding for investors seeking to deploy leverage in the troubled lending areas. In our research and market updates over the past year and a half, we have consistently advocated a three-part solution for the financial system:

1. Remove the toxic assets
2. Recapitalize
3. Reinitiate lending

The devil, as always, is in the details, but we see the PPIP, in particular, as an elegant means of addressing the challenges around the first task and the good bank/bad bank approach we have advocated for some time. We think that the expanded TALF should complement the success of the Commercial Paper Funding Facility (CPFF) and Temporary Liquidity Guarantee Program (TLGP) by getting credit to consumer and commercial borrowers through the Fed. We do have some reservations about the implementation of the PPIP and TALF, but we are hopeful that policymakers will address investor concerns sufficiently to get capital moving again.

Many on both sides of the political aisle have derided the fiscal stimulus program. While we could improve the package too, the key point to recognize is that the stimulus will likely decrease the short-term economic pain that we would have endured in its absence. The trade-off is, clearly, an even larger public debt and the long-term cost of repaying it. As we have noted in the past, the total government debt to GDP ratio in the United States is now above 85% (60% held by non-government investors and 25% owned by the Social Security Trust Fund).[1] We believe this ratio may well reach 125% over the next several years, as the enormous budget deficit of 2009 is only the beginning of historic government intervention in the economy.

The key fact to keep in mind in the midst of this major deficit spending is that the alternative decision, not intervening, would almost certainly have resulted in much higher unemployment. As an example, the grants to state and local governments alone should directly prevent government job losses in the hundreds of thousands, meaning these people continue making their mortgage payments and spending money in the private sector. It is very difficult to calculate what impact saving these jobs will have on consumer spending, but it is intuitively obvious that spending will be higher than it might have been otherwise.

In spite of the positive short-term impact of the fiscal stimulus, however, we now anticipate that unemployment may well peak at levels in excess of 10%. Were it not for the fiscal stimulus, 12% would not be out of the question, implying a broad range of ramifications for the financial sector and the broader economy.

THE ROAD AHEAD – FOCUS ON HOUSING

A number of plans were released over the last year, culminating with the Obama administration's Housing Affordability and Stability Plan, however we have made little progress in addressing house prices in the United States. We think that the primary problem with most plans offered to date is that they address the housing problem one borrower at a time. Considering that there are already over 4 million borrowers in default on their mortgages and another 10 million people behind them with negative equity, an individualized approach to housing is simply too unwieldy to implement quickly enough to help.

The Fed has actually had the most significant impact on housing through its purchases of MBS. Through April 8, the Fed has purchased $333 billion of MBS out of a planned total of $1.25 trillion.[2] The Fed purchases can be credited in large part for the over 200-basis point decline in mortgage rates since the purchases were announced late in 2008. Given that every 100-basis point decline in the mortgage-borrowing rate reduces a buyer's monthly payment by about 10%, the Fed has cut the cost of buying a home by approximately 20%.

Unfortunately, even with the substantial reduction in interest rates, we expect an additional 22% to 27% decline in home prices from the most recent observation. We estimate that the average American with a mortgage had only 12% equity in his home at the end of January. If home prices decline in line with our forecast, that would imply that over 30 million homeowners could have negative equity within the next year. Moreover, the consumer would see another $4-5 trillion wiped off their balance sheet, leaving an equity position of approximately $47 trillion (consumer assets less liabilities ended 2008 at $51.5 trillion, down from a peak of $64.4 trillion at the end of the second quarter of 2007).[3] The clear implication of this balance sheet deterioration would be less spending, more saving, and higher unemployment, as the economy downshifts to a new level of normalized consumption.

Ultimately, we think that the policy tools the government will use to address housing need to be blunt to have an impact quickly enough to matter. Besides interest rates, the most powerful tool is the tax code. The fiscal stimulus included a tax credit for first-time homebuyers of up to $8,000, but the limitation on income (and the fact that it is only for first-time buyers) minimizes the effectiveness of the credit. We would advocate a much larger tax credit for any buyer of an existing home. The credit should exclude new homes, as the goal is not to increase supply of new houses, but rather to create demand for the existing excess supply.

Given our concerns around housing prices, it should be clear that we are scrutinizing all incoming data to determine if our forecast remains on track. The January data was in line with our expectations, in spite of a short-term benefit to prices coming from a foreclosure slowdown put in place by the major servicers late in 2008 and into 2009. This slowdown in the processing of foreclosures likely reduced the supply of homes for sale by as many as a 300,000.[4] To the extent we see better data, we will need confirmation that the foreclosure slowdown is not the only driver of the improvement.

A SHOOT OF GREEN? IS MARKET PSYCHOLOGY TRANSITIONING?

The beginning of a process of differentiation is one very encouraging sign coming in the first quarter of 2009, which we hope to see confirmed. In much of 2008 and into 2009, the market was best characterized by panic, with investors selling assets across the board. We believe we are at the beginning of a stage in which investors feel more confident in their ability to identify winning companies and shun losers.

The most explicit evidence so far comes from the investment grade debt markets, where we saw $868 billion of issuance globally in the first quarter of 2009 versus $455 billion in the previous year. Even backing out $381 billion of government-guaranteed debt, issuance was up.[5] This is impressive, considering that much of the guaranteed debt was issued by prominent issuers from the first quarter of 2008 (when there were no such guarantees). On the other end of the spectrum, high-yield issuance remains very weak, as risk considerations currently overwhelm rewards in that arena. The willingness of investors to commit to certain issuers and shun others is encouraging, as it indicates confidence that analysis is relevant and returns may justify the risk. We think this psychological shift is important for a number of reasons:

1. Systemic stabilization. In a period of panic, companies that would normally be able to access credit markets find that funding disappears for extended periods of time. This disruption of normal access to capital markets decreases the confidence of investors in their ability to assess risk, adding to the lack of available capital. To the extent we have reached the point where investors are regaining confidence in their ability to assess the future prospects of companies, we would expect to see capital flow to the companies that are best positioned in terms of both creditworthiness and earnings growth prospects.

2. Pricing returns to the fore. In a period of differentiation, there are effectively two sub-stages. In the first sub-stage, capital is available only to the companies deemed to be winners. In the second sub-stage, access is extended to other

companies that are not necessarily winners but are deemed to be survivors. These companies, however, face a differentiation in terms of pricing and terms for the capital they receive.

3. Reinforcing competitive advantage. Ultimately, the companies that entered the crisis in the best condition, and exit it with the brightest prospects, find themselves to be the beneficiaries of a comparatively lower cost of capital than their less well-positioned competitors. This lower cost of capital allows the strong to not only survive, but also emerge even stronger. We are seeing this already in a range of industries from financials, to healthcare, to technology.

4. Eventually reducing discount rates on future cash flows. One characteristic that has been particularly challenging for credit markets has been the ever-increasing discount rate applied by investors to future cash flows, reflecting the extreme uncertainty around future events. As markets begin to discriminate amongst issuers of debt and equity, we would expect discount rates applied to their future cash flows to begin to decline to levels that reflect more normal assumptions regarding risk premiums relative to risk-free rates. Over time, we will revisit this topic, as the key question will be more around inflation rates rather than survival.

We will be watching carefully to see if this new psychology can take root and sustain itself through 2009. We believe the key consideration here is to appreciate that it is easy to slip back into panic mode after the experience market participants endured in 2008. While it is difficult to imagine what could tip us back into that mindset, it is worth remembering that surprises are by definition unexpected.

OUR INVESTMENT FOCUS

Our focus remains unchanged. We seek to understand and leverage the relationship between financial productivity and valuation. The key factors we look for in stocks are:

- Strong organic cash flow
- Balance sheet strength
- Market leadership position
- Operational flexibility

We believe that this cycle is anything but a typical one, and that managers who look backward for guidance are likely to destroy value for their clients. In our opinion, now more than ever, it is imperative to be forward-looking and to understand the changing environment in which companies operate. We believe this is a cycle in which the strong will not only survive but also get stronger. A common view is that lower-quality companies provide the best offense during the early stages of an economic recovery. It is our view, however, that in a world where financial leverage will be more difficult to access, and more costly, the next economic upturn will be characterized by industry leaders gaining market share, expanding their competitive leadership, and leading the way in a stock market upturn. The elements that comprise our investment focus are honed to identify such companies. While many of these leadership companies have been viewed as having defensive characteristics during the downturn of the past six quarters, we believe they will come to be viewed as the new offensive ones.

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

EUROPEAN EQUITY

Seeking Out the Jewels Amongst the Rubble

Equity markets continued to fall in the first quarter of 2009, as the FTSE World Europe ex-U.K. Index ended the period down approximately 16%. More positively, global equity markets, including Continental Europe, rallied strongly in March against a backdrop of high-profile government action intended to stimulate demand and improve the flow of credit.

It appears that the wide-ranging economic stimulus measures implemented by governments since October have started to create an impact, hinting of a swifter recovery than had been feared by some. Nonetheless, the corporate environment remains poor, but the European consumer is stronger than those in other parts of the world, due to higher savings rates and less exposure to housing bubbles.

Although superficially this may seem to be a poor environment for investing, longer-term opportunities remain. Valuations are even more attractive than at the start of the first quarter, with many high-quality companies still trading at a significant discount to their long-term value. Furthermore, we believe that the testing economic conditions should benefit strong companies, allowing them to become stronger. Access to credit has resumed, but it is still restricted to companies perceived to be lower risk—meaning that lower-quality companies with weaker balance sheets may face acquisition by larger competitors or may disappear altogether, as opportunities to refinance remain scarce.

The ability to sustain profits through a difficult macroeconomic environment is now paramount. We believe that firms with a dominant market position or a strong brand are best placed to generate sustainable returns in varying market conditions.

The bottom-up perspective still appears poor, as company managements we met with reported that the macroeconomic environment is deteriorating further, with no clear signs of improvement in many areas. However, glimmers of hope exist with a few forward-looking indicators, such as economic surveys, showing some signs of bottoming out. Monetary stimulus has progressed further, with quantitative easing in the United Kingdom, the United States, and Japan being received favorably by the market. Even though unemployment is rising, the European consumer has continued to spend—albeit at reduced levels from last year—and at a more encouraging rate than the rest of the world.

By sector, we currently have a preference for health care and consumer services and have reduced exposure to consumer durables and apparel, while staying underweight in financials. We continue to seek companies with quality assets that are highly financially productive or those where financial productivity is increasing significantly.

Due to the very severe correction seen in European equities, we are finding opportunities at increasingly attractive valuations. Atlantia, the Italian motorway toll operator, has been de-rated—despite resilience of traffic volumes—more than other European peers, which have all fallen on reduced traffic volumes. However, traffic volumes decreased less in Italy, as there is no viable road alternative to the motorway for many journeys there and, in addition, the rail network is quite poor, so freight traffic tends to stay on the motorway. Daimler, the high-quality franchise in the auto industry, has fallen to an attractive valuation level. Despite uncertainty over short-term trading, we believe the long-term outlook for Daimler looks better than its peers, as the company has a strong balance sheet and its products are more differentiated and more robust than those of its peers. Thales, the French aerospace systems and industrial electronics manufacturer, has an interesting mix of defense contracts—which are “defensive”—plus a number of strong franchises where spending remains strong, for example rail signaling and air traffic control.

By sector, consumer services is our largest overweight. The European consumer has been less impacted by the global downturn and sales remain surprisingly robust, with exposure to growing markets and the ability to take advantage of weak competitors. Opportunities here include Metro, Carrefour, Ryanair, and Vivendi. The ongoing strength of revenues in the health care sector is, in our view, not reflected in current valuations, and cash flows have been largely underestimated. In the industrials space, we have been very stock specific, focusing on non-cyclicals such as Atlantia and Thales, as mentioned before. Finally, we continue to be cautious in the financials sector, remaining underweight banks and becoming more

focused on national champions and high-quality franchises. We have increased exposure to insurance firms, adding to Zurich Financial Services and Allianz.

The positive response to further fiscal and monetary stimulus and the resulting March rally were the first real signs of optimism in this cycle. However, the corporate environment remains poor and this continues to drive us to be very stock specific. As we have consistently emphasized, we firmly believe that the quality of companies is still extremely important. Nevertheless, we think that a focus on high-quality, cash-generative companies should help investors to find the resilient stocks needed for the short term and leave them well positioned for the long term. With markets down thus far this year, we believe there are increasing investment opportunities across a wider range of sectors, and we continue to seek out these "jewels amongst the rubble."

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

JAPANESE EQUITY

Crunch Time

The bear market that has gripped the world has generated a number of superlatives for investors, most linked to the Great Depression. Hence, media publications are full of comments on "the biggest decline since…"-type hyperbole, which sharpens the debate and contributes to political popular bashing of the rich and attempts to bail out those who suffered the most. In the midst of this, markets appear to have hit a cathartic bottom, from which they have risen—pardon the superlative—at the fastest three-week pace since 1937 during the Great Depression. In Japan, which has largely followed global trends, one of the most noteworthy developments has been the outstanding performance of the auto sector, Japan's most globally exposed cyclical industry.

What does this imply in terms of investors' outlook on the world? First, let's examine some facts: The world has the capacity to produce 73 million automobiles a year. Current global demand is running at 50 million vehicles. The 32% excess capacity guarantees that no auto manufacturer in the world can make money. Historically, due to mix and regional demand variances, 10% excess capacity was the level at which most companies could make decent operating margins. Thus, either demand for autos has to rise 32% or capacity has to be drastically cut to restore profitability. Unfortunately, every country in the world is engaged in subsidy programs to keep auto makers alive and ensure manufacturing jobs are maintained. Without the creative/destructive capitalist influence to force production cuts, restoring balance will be entirely dependent on rising end-demand.

Japan is in a particularly difficult situation. It produces 10 million autos domestically for a country that only purchases 4 million in a year. Excess production is exported, overwhelmingly to developed countries, with the United States as the major destination. Structurally, this is an unsustainable business model. Long-term demand growth for autos is coming not from Europe or the United States but from developing nations, most notably China. Expensive Japanese cars produced at home are not competitive in the Chinese, Indian, or other emerging economies. Low-cost local production is essential. Thus Japan faces a situation in which it will have to move the production of 50% of its total automobile capacity offshore in the coming years in order to remain competitive in this industry. The economic implications of such a wrenching change and its impact on the auto companies and their supply chain are enormous.

This is what makes the phenomenal performance of the auto companies so interesting. Faced with a long-term structural challenge of such importance, we believe profitability is certain to remain subdued for years to come. Yet, investors seem more intent on the implications of a near-term recovery in demand and production, which will make the magnitude of the losses somewhat less than previously anticipated. But the fact is these companies will remain loss making for a long time, and peak margins are unlikely to exceed 2%. Similar blue-sky investment thinking is being replicated in a number of areas exposed to developed country personal consumption, notably the consumer electronics field.

The concern in the coming quarters is how the market is likely to respond to a recovery that is insufficient to move the auto and electronics industry out of the red. As an example, U.S. auto sales would have to rise 40% for the Japanese makers to become profitable again. While the move in the sector during the first quarter of this year was driven by the hope for a profit recovery, news flow in the coming months will be the catalyst for whether there is any fundamental basis in the hope and hype. Given the sheer volume of recovery necessary to restore profits, it is likely that disappointment will be the outcome. Now that the edifice of a recovery has been established by the market, it is crunch time to determine whether it can be sustained. If the reality is a more prolonged downturn in demand than hoped, the automotive and information technology sectors will suffer, and so too will the Japanese market.

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

EMERGING MARKETS EQUITY

Remaining Optimistic Despite the Downturn

It may be too soon to claim with conviction that the darkest days in the global equity markets lie behind us, but a slightly positive first quarter for emerging markets equities has given investors some limited, but long overdue, cheer.

Two distinct and welcome observations, both with important ramifications for emerging markets, can be made about the current investment environment. First, governments in the developed world are, by and large, pulling out all the stops to reflate their declining economies. If successful, these efforts will likely help exporters in emerging markets. Secondly, U.S. and European governments are spending vast sums of taxpayers' money on subsidies, asset insurance schemes, and recapitalization programs in a bid to avoid the 100% nationalization of their domestic banking systems. As a result, some of the uncertainty surrounding the survival prospects of Western financial institutions is slowly dissipating; investors now have a clearer sense of those financial companies that will make it through the subprime crisis, although this chapter is probably yet to be fully written and there may be one or two more shocks ahead. This easing of the uncertainty surrounding the financials sector is of critical importance. The restoration of stability to the global financial system, which we believe will happen in 2009, will be a vital component in any tangible recovery in the stock markets. It will be especially helpful in casting off the shackles currently holding back emerging markets, where underlying fundamentals are, broadly speaking, significantly better than in the developed world.

The economic outlook for emerging markets inevitably varies by country, but, overall, we remain optimistic about the growth prospects for the developing world. Despite the pronounced economic downturn in the developed world, it remains reasonable to project economic growth of 2% to 8% per annum across the broad emerging markets over the next three years. There will doubtless be pockets of weakness—the economies of Mexico (on U.S. economic woes), Russia (depressed energy prices), Eastern Europe (a burst property bubble and excessive indebtedness), and South Korea (export weakness) could contract significantly over the near term. Other export-oriented Asian economies are also facing the challenge of a global downturn that has surprised with both its speed and intensity. Yet, encouragingly, our research suggests that the economies of Indonesia, Philippines, and Thailand are performing reasonably robustly despite the collapse in demand in the developed world. Elsewhere, despite the dive in commodity prices in the latter half of 2008, many Latin American and South African companies are showing relative resilience.

The overall prospects for emerging markets equities appear compelling based upon their valuations and profitability, particularly when compared to their developed world counterparts. Generally, the asset class is not facing the same type of leverage or solvency issues plaguing the Western financial system. We view the current weakness in emerging markets as a global crisis of confidence, and we believe that performance will become focused on fundamentals once fears over the solvency of the Western financial services industry are addressed. To that end, we remain optimistic on the asset class over the short, medium, and long term. We can probably expect emerging markets to see-saw over the next several months, as

major bear market rallies are punctuated by sell-offs caused by negative surprises and adverse situations. But looking beyond what is likely to be a volatile period of trading, we anticipate significant share price strength as markets stabilize.

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

NOTES:

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1 Source: U.S. Federal Reserve, Lazard Asset Management

2 Source: U.S. Federal Reserve

3 Source: U.S. Federal Reserve, Lazard Asset Management

4 Source: Lazard Asset Management

5 Source: "Underwriting Gains on Stimulus, but Fees Take a Hit," The Wall Street Journal, 1 April 2009

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Lazard Asset Management LLC

30 Rockefeller Plaza
New York, NY 10112-6300

www.LazardNet.com