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 U.S. Federal Reserve (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.

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NOTES:

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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