LAZARD

2009Q3 **Outlook**

JULY 2009

Outlook for Global Equity Markets

Stock markets rebounded strongly in April and May amid signs that the global economy was "less bad" than it had been in the recent past. In June, reality seemed to set in, and earlier optimism was tempered by concerns over the shape of the projected recovery. While all sectors displayed positive performance for the quarter, the sectors with the best performance were those that had been the hardest hit prior to the recent rally. The financials sector benefited from improving expectations and from continued stabilization in the credit markets, which assuaged earlier fears. The materials sector also witnessed strong gains due to increased demand from emerging markets, which displayed resilience amid the global recession. Meanwhile, defensive sectors such as health care and telecom services lagged, as investors rotated into more cyclical exposures on the back of recovery expectations.

Valuations have moved a long way since the aggressive rally that began in early March. The impact of quantitative easing on financial assets has been profound, and is likely to continue to have dramatic consequences. However, we believe that more significant evidence of genuine economic improvement globally will be necessary to sustain the rally. In our view, the willingness of investors to return directly to the leaders of the last boom/bust cycle and focus on companies with low productivity is unsustainable. We remain concerned about the implications of rising unemployment, rising taxation, deleveraging, rising bad debts, slowing consumer spending, cuts in capital expenditures, and the imbalances caused by the enormous fiscal and monetary interventions.

We believe that in this environment, it is imperative to be forward-looking and to understand the changing landscape in which companies will operate. We also believe we are now in a cycle in which the strong will not only survive, they will get stronger. It is our view that, in a world where financial leverage will be more difficult and costly to access, the next economic upturn will be characterized by increased market share by industry leaders, who will expand their competitive leadership, and lead the way in a stock market upturn. While the global economy's rate of decline is slowing (i.e., "less bad"), most of the world remains in recession and faces numerous credit and growth challenges.

U.S. EQUITY

Navigating Normalization

Through the second quarter, the markets continued to recover from the violent action of the previous 18 months. The transition from what could be characterized as panic to differentiation merely represents the beginning of a multi-year phase in which we expect the winners to capture market share from the losers and mere survivors. We think that this period of differentiation creates significant opportunities for forward-looking, fundamentally driven investors who can identify companies that are positioned well within each sector. We see the winners as the companies that have balance sheet strength, strong organic cash flow and operational flexibility.

While we see great opportunity in the markets, we also believe it is important to recognize the fragility of the underlying economy and the likely shape of an economic recovery when it comes. On this topic, we will review:

1. Our updated analysis of U.S. house prices: We believe we will see positive news on house prices for the next three months, followed by a reacceleration to the downside

2. The state of the credit markets: While markets appear to have recovered, we are increasingly concerned that the U.S. Federal Reserve has been the pivotal driver of this improvement.

3. Our view of inflation risk: Inflation is a concern, but our current base case scenario is that labor weakness will outweigh commodity inflation, leading to a low, if not zero, inflation rate over the next several years.

Ultimately, we believe the U.S. consumer and leverage will not lead the recovery. Instead, in our view, we will see a long-term recalibration of economic activity with much more government participation in the economy until deleveraging is accomplished and the United States becomes more competitive in existing or new industries.

THE QUARTER BEHIND US

There have been a number of positive and negative developments in the second quarter.

Positives:

- Appetite for corporate credit expanded. High-yield issuance quadrupled sequentially to just under $50 billion in the second quarter. Investment-grade issuance declined 25% sequentially to $294 billion, largely as a result in a decline in FDIC-guaranteed debt by banks.[1] The key positive is that many companies have the opportunity to term out debt at low absolute rates. Higher-risk companies have been able to issue as well, but only at high absolute rates.

- Home price declines began to decelerate. As we expected, the most recent home price data indicated a decrease in the pace of declines, as the foreclosure moratorium and the lower mortgage borrowing rates began to offset underlying house price weakness. The 0.9% decline in the S&P Case-Shiller 20 City Composite Index for April was less than half the decline of the prior three months.

- The largest U.S. banks raised over $65 billion of capital in the quarter.[2] We believe this capital is adequate to carry these banks through our bear case scenario, mitigating the potential for a systemically important failure.

Negatives:

- Unemployment has increased faster than most had expected. Our base case expectation is now for unemployment to reach levels as high as 11% or 12% over the next 18 months. Perhaps more troubling, we are seeing increasing evidence of employers reducing wages and hours worked, putting more financial pressure on consumers.

- The banks that were not subject to the stress test (the ones ranked below the top 19) have not raised adequate capital, in our view. While there are clearly banks that are small and well capitalized, regional and community banks tend to have a much higher exposure to commercial real estate and construction loans than the largest banks. We continue to expect large numbers of bank failures among these lenders.

- Our early enthusiasm around the Public-Private Investment Program (PPIP) appears to have been misplaced, as the effort faltered. We had viewed the announcement of the PPIP in the first quarter as a sign that the government had identified a way to help remove toxic assets from the financial system. While some version of PPIP may still happen, we now view it as being less likely to have a meaningful impact on the financial system.

U.S. HOUSE PRICES: GOOD NEWS TO COME, FOLLOWED BY BAD NEWS

In the second quarter, the foreclosure moratorium and the lower mortgage borrowing rates meaningfully impacted home prices. In our home price model update at the end of May, we indicated that we had not explicitly incorporated mortgage borrowing rates into our model, but that we expected the rate decreases to offset as much as 16% to 22% of the decline predicted by our model. While we did not see any material impact early in the first quarter, we did begin to see interest rate declines reduce the downside in house prices in the March and April data released at the end of May and June, respectively. In particular, the April data was meaningfully impacted, as the pace of price declines was cut in half.

Over the two to three months ahead, we believe we will see Case-Shiller price index declines that are even smaller. We might even see sequential month increases in the index. This expectation is a result of the following three factors:

- The Case-Shiller index is a three-month moving average. Hence, the April report actually reflects home transactions in February, March and April.

- The foreclosure moratorium impacts transaction prices on a lagged basis. Homes that would have been foreclosed in November 2008, when the moratorium began, still would not have been sold for several months, impacting prices in February or March, at the earliest. Given that the moratorium was in place from the end of October 2008 to mid-March 2009, the impact may be felt through the rest of the year. However, when we get to the June or July price data (released in August and September, respectively), we will have fully incorporated the impact into comparisons, such that month-over-month changes will be like-to-like comparisons.

- Mortgage rates also have a lagged impact. Borrowing rates for 30-year fixed rate conforming mortgages declined most significantly from November to December of 2008, from 6.22% to 5.63%.[3] Mortgages originated in December, however, probably did not close for 60 to 90 days, given the high refinancing volume at the time. This would mean that a loan agreed in mid-December would actually not close until mid-February to mid-March. As a result, with the April data we are now seeing 1.5 to 2.5 months of interest rates reductions in the data. The next major monthly step change in rates happened in March, when rates fell by 40 basis points to 4.95%. March rates will not be fully reflected in the Case-Shiller price index until we get to the June and July data.

We think that the impact of the foreclosure moratorium and the changes in interest rates is not understood well relative to the Case-Shiller data. Hence, we believe opportunities may arise around the times of the data releases, as investors begin to believe that housing has stabilized.

We do not believe this data represents the end of the house price decline. Instead, we see the short-term stabilization as the realization of the factors we did not include in our model, leaving the remainder of the home price declines still in front of us late in 2009 and into 2010. Put simply, while there are trading opportunities around data flows, one should be careful to not get whipsawed.

Ultimately, after we enjoy the short-term stabilization, we still see downside in U.S. house prices of as much as 20% to 25%, assuming mortgage rates stay at end-of-June levels and that no additional tax incentives are offered at the federal level to pull-forward demand for existing homes.[4] Taking this insight into account alongside our new research around consumer savings, we are confident that the recovery will not be led by the U.S. consumer.

CREDIT MARKETS: RECOVERING OR BEING PROPPED UP?

Credit markets have continued to show signs of improvement through the second quarter. Spreads have compressed across the board, as measured by cash and derivative instruments. In spite of the signs of life in credit, we are increasingly concerned that the U.S. Federal Reserve might be far more important to the recent activity and spreads than people realize. Just to put the purchases into context, during the first half of the year, the Fed and U.S. Treasury Department combined purchased almost $700 billion of mortgage-backed securities (MBS). These purchases comprise the vast majority of all MBS issued in the United States.

But the story does not stop there. In the first half of 2009, the private sector (including Fannie Mae and Freddie Mac) issued \$1.18 trillion of debt.[5] Approximately \$900 billion more of asset-backed securities (ABS) and MBS were issued as well.[6] These figures imply that the Fed and the Treasury purchased approximately 35% of all of the private sector debt issued in the United States in the first half of 2009.

Investors seeking yield quickly found that agency MBS were no longer attractive given the Fed purchases. Having effectively crowded out almost all competition from the MBS market, one could argue that the Fed and the Treasury have forced \$700 billion of demand into other credit instruments.

That was the goal, and we think that the Fed and the Treasury succeeded. By forcing demand out the credit curve, the purchases of MBS not only narrowed spreads for mortgages, reducing rates for borrowers and supporting home prices, but also forced down the cost of funding for every other borrower that could get funding in the debt markets.

The big question is "what happens when the Fed and the Treasury stop buying debt?" While there is no definite answer, given that we do not know the Fed's strategy, what is clear is that the bid at some point will have to dissipate and ultimately disappear. Handling this process is not impossible, but we believe will be incredibly difficult to manage. If the Fed stops buying too abruptly, spreads might increase significantly, derailing economic recovery. If the Fed continues buying, it risks increasing long-term inflation threat, given that these purchases are all funded by "created money," i.e., no bonds are issued to fund these purchases by the Fed. The funding comes from crediting the excess reserve accounts of member banks. The banks cannot use this money, as the Fed has already used the funds to buy MBS and Treasurys. This "printing of money" will ultimately be inflationary if the Fed does not pull the punch bowl away at the right time.

Clearly, the buying will have to stop at some point. There are discussions in credit markets about the "exit plan," but we worry that the ramifications of the exit, however accomplished, might be more severe than investors appreciate.

INFLATION: RIGHT CONCERN, WRONG TIMING

There are two primary ways to approach inflation:

- Monetary policy, which approaches the topic from the perspective of too much money chasing too few goods
- Fundamentals of the economy and an examination of where the inflation is likely to be seen

Our current base-case scenario is that inflation will not be an issue at the headline CPI level in the United States for the next several years. Why?

- While money supply has increased meaningfully, the degree of printing has been exaggerated. The amount of cash that has been created by the Fed to date to fund asset purchases has been approximately \$1.8 trillion, or 13% of GDP. While this is very large, the velocity of money has decreased enough to more than offset this increase. Put simply, the money is there, but it is not chasing anything, at this point.

- From the economic perspective, labor represents 70% of the cost of goods sold in the United States.[7] Our base-case scenario has unemployment rising as high as 11% to 12%, with underemployment (including discouraged and marginally employed workers) perhaps reaching 20%. We are already seeing anecdotal evidence of employees taking wage cuts, furloughs, and reductions in workweeks to avoid losing their jobs. All of these actions equate to wage reductions.

- Putting these points together, it is very difficult to foresee a situation in which employees in the United States will be able to demand wage increases, even while we suffer through unemployment levels not seen in over 50 years. We do envisage commodity price inflation to the extent that other economies recover before the United States. This would make sense, as commodities are priced globally. Labor, however, is local. Given the degree to which labor drives the cost of goods sold, and hence pricing to a large degree, we simply do not see near-term price pressure in aggregate. The key assumption here is regarding labor. To the extent our base case assumptions are wrong on unemployment, this view will clearly change with new data.

While these points are relatively straight forward, the analysis is anything but. There are many questions to address around inflation, including how the Fed and the Treasury wind down their intervention, i.e., sell the assets after they stop buying them. Why? Until the securities are sold, the money the Fed used to pay for them remains in circulation. At some point, unemployment will decrease and wage pressures will return.

If the Fed has purchased 30-year MBS with coupons of 4.0% to 4.5%, it may well find that selling the securities requires it to realize a very large loss (e.g., 20% of $1.25 trillion would lead to the requirement of a cash infusion from Treasury of $250bn that would then have to be funded out of the annual federal budget). Alternatively, the Fed could simply sit on the MBS and earn 4.0% to 4.5%, less the losses from credit. The problem with this approach is that at some point the velocity of money will increase with economic recovery, and inflation will be much harder to contain with a massive increase in money supply.

This is only one example of complications that arise from the new forms of intervention we have experienced. We will continue to analyze these issues and provide updates as our views evolve.

FRAGILITY AND THE SHAPE OF ECONOMIC RECOVERY

The bottom line is that the economy remains fragile. With more home price declines likely later in 2009 and into 2010, we expect consumers to continue to increase their saving rates, decreasing their ability to lead the recovery. With banks capital constrained and credit markets dependent on the government, leverage is also unlikely to lead the recovery.

All of this begs the question of what will lead the recovery. The answer is not clear to us. What is clear is that discussions of V-, W- and L-shaped recoveries are misplaced. Even more dangerous, in our view, is investing by looking backward. This recession is unlike any in most of our professional lifetimes and the recovery will be as well.

We believe that investing successfully in a changing environment requires a forward-looking perspective that facilitates identifying winners, mere survivors, and losers. Our investment focus is on finding companies that have balance sheet strength, robust organic cash flow, and operational flexibility, as we believe these are the characteristics that will ensure not just that the winners will survive, but that they will thrive. By understanding the environment in which companies might operate, we will leverage our scenario analysis and bottom-up fundamental analysis to identify and invest in the winners and seek to dodge the losers.

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

EUROPEAN EQUITY

Focus on High-Quality, Financially Productive Companies

European markets rallied strongly in the second quarter, as signs of a recovery appeared. In April, a number of strong first quarter earnings reports and more optimistic assessments on the global economy provided an upbeat tone, which resulted in an increase in performance in April and May. Data releases have been more varied over the past two months, and the market did cool in June, as many assess the prospects for the macroeconomic recovery in the second half of the year.

As many valuations were beginning to price-in Doomsday scenarios, it is not surprising that the market bounced after it appeared clear that a depression had been avoided. Having said that, the rebound in performance of European equity markets in the second quarter does not imply that the status of the real economy is changed dramatically. Our view, gleaned from meetings with many of Europe's top companies, is that the corporate environment still remains relatively poor. While economic surveys are beginning to look more positive, it must be considered that they are coming from a historically low base.

From a macroeconomic perspective, it should be remembered that Europe is in better shape than many other regions. Household debt is significantly lower, because when the rest of the world was leveraging up, ahead of the downturn, core parts of Europe were already deleveraging. This has left Europeans with a strong household balance sheet, and while demand has been relatively low, we believe the prospects for a recovery are sound.

The recovery has also been helped by new issuance in bond and equity markets, and indeed some companies have been able to raise new financing for proactive, rather than defensive, purposes. This has enabled some of the weaker companies to survive, while stronger companies have recovered quicker than anticipated.

Looking forward, we think that there are three major themes for investors to contemplate in the second half of 2009:

- First, we believe that a growing emphasis will be placed on analyzing companies' underlying levels of activity and demand. As we move towards the end of 2009, the supportive wave of economic sentiment may start to dissipate, revealing levels of activity and demand that may not be as positive as some commentators are currently predicting. This is particularly true when one considers the likelihood that many companies will be operating with excess capacity for some time. The impact of this on profitability could be significant for many companies

- Second, what will be the reaction if analysts' 2010 consensus estimates have been too optimistic? Over the past year, sell-side estimates have swung widely on market sentiment, often overestimating the real impact at both ends of the spectrum. However, as analysts have largely not factored in the same level of downturn for 2010—it appears as though near-peak margins are being factored in for the non-financial sectors of the market—revisions are likely

- Finally, we believe there are significant stock opportunities arising in high-quality companies where the valuation is now compelling

As a consequence of these factors, we believe the recovery, however shaped, will be more stock specific than what the equity market is currently pricing. The ability to sustain profits through a difficult macroeconomic environment is now paramount, and we think that firms with a dominant market position or a strong brand are best placed to generate sustainable returns in varying market conditions.

At the sector level, we favor: consumer services, as the European consumer has been less impacted by the global downturn and sales remain surprisingly robust; health care, as, in our view, the ongoing strength of revenues in the sector is not reflected in current valuations, and cash flows have been largely underestimated; and industrials, focusing on non-cyclical companies.

The positive response to further fiscal and monetary stimulus and the second quarter rally were the first real signs of optimism in this cycle. We believe that the equity market will continue to be volatile and that the recovery is unlikely to be in a straight line. However, investors can take heart that some valuations remain attractive and that the potential for returns to be generated from bottom-up, fundamental stock picking has been much increased due to the sell-off. As we have consistently emphasized, we firmly believe that the quality of companies is still extremely important. We think that a focus on high-quality, cash-generative companies will help investors to find the resilient stocks needed for the short term and will leave them well positioned for the long term.

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

JAPANESE EQUITY

Who to Believe

Corporate earnings for fiscal year 2008 in Japan have come and gone. The news was desperate, particularly for those companies largely exposed to the global economic cycle. In aggregate, earnings per share for the TOPIX Index fell into negative territory for the year, driven by massive losses at auto and electronic firms. Only a very few of Japan's leading manufacturers managed to report positive earnings. A look at the companies that did manage to increase corporate value in such a difficult environment suggests a number of commonalities, which we believe point a way for identifying long-term winners. Interestingly, these common features were more related to competitive positioning and management than to the specific industries where these companies competed. In addition, the outlook provided by these companies paints a decidedly different picture of how the environment may trend over the course of 2009 compared to commonly accepted views.

Some of the companies that produced positive absolute earnings during 2008 include Nidec, a maker of spindle motors, Shin-Etsu Chemical, a maker of PVC, Rinnai, a maker of hot water heaters, Makita, a maker of hand tools, and Daikin Industries, a maker of air conditioners. All of these firms enjoy a sizeable market share in the products they make. They also tend to earn money in both the developed and developing markets, providing a more diversified profit base. All of these companies were able to maintain pricing more effectively than their rivals, despite a drop-off in volumes similar to other durable goods makers. All of them acted relatively swiftly to cut costs and lower overall breakeven levels in an effort to support profitability. In summary, we think that the winners tended to have a substantially greater control over their own financial destiny.

In contrast, the firms that produced huge losses were hostages to the environment. As demand for goods dropped, pricing fell precipitously. As the losers tended to be in very competitive industries, already low levels of profitability quickly turned into "red ink." Typically, we believe that managements of these companies were slow to respond to the new environment. As the previous few years had been driven by investments focused on market share gains, we think that most managers felt the downturn was likely to be a temporary event and were unprepared to take immediate steps to cut longer-term investment objectives. The consequence was that, as the slowdown intensified, losses ballooned and a rush to slash production and cut inventories ensued.

As the developments discussed above transpired at exactly the same time financial budgets for the full year 2009 were being put together, we think that a review of what the outlook implies for the rest of the year is instructive. Generally, the stronger companies, which were able to manage profits despite the collapse in demand, are forecasting that 2009 earnings will follow a fairly similar pattern. Most of these companies see little signs of a pick-up in the first half of the year and see only a modest improvement in the second half; because they were generally quicker to cut costs, and have more control over pricing, they forecast profits to remain positive throughout the year. In contrast, the weaker companies, while projecting a small pick-up in the first half of the year, are expecting a rapid "V-shaped" recovery into the second half. This is interesting, as it is a necessary prerequisite for this group to manage to achieve profits for the full year. Thus, in aggregate TOPIX Index earnings are forecast to be down 70% year-over-year in the first half, and up 624% year-over-year in the second half.[8]

In essence, the companies that, thus far, have managed the cycle far more effectively have remained resolutely conservative for 2009; those who were overwhelmed by cyclical forces are the most optimists for a recovery. The question of who to believe is finely balanced: the nascent recovery in stock prices would support a "V-shaped" optimism, but it would seem more credible to put faith in those companies that have been ahead of the curve in managing this cycle. If the winning firms are right, investors may expect a healthy dose of second-half earnings disappointment.

Written by:
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The More Dynamic Economies of the Next Decade

After an extraordinary performance in the second quarter of 2009, valuation of emerging markets equities have increased from high-single-digit P/E multiples to low-to-mid teens P/E multiples. Given our bottom-up fundamental approach to determine future potential upside, and the unprecedented amount of recent flows into the asset class, we have changed our positioning in emerging markets: we are now neutral in the short term, constructive in the medium term, and bullish in the long term.

Although emerging countries are now being hurt by the global recession, it is increasingly clear, in our view, that they will be the more dynamic economies over the next decade. We believe that central banks around the world are taking the right steps to restore and ensure financial stability in the developed world, and that this will help emerging markets to continue their secular development, albeit at a lower pace over the medium term. In our opinion, fundamentals are currently significantly better in emerging markets than in developed markets, and they are likely to continue to be good for the longer term. Despite this, and the fact that emerging markets have recorded 28 consecutive quarters of higher profitability and have a better earnings-per-share growth profile, on a price-to-earnings basis they are still trading at a discount relative to the industrialized world.[9] Given this picture, we think that relative valuations of emerging markets equities, currently at mid-range levels over the last twenty years, are not expensive. We anticipate large-scale demand for basic manufactured goods and commodities, now and even more in the future, and relatively strong economic activity with no need for currency pegs.

We believe there is a noticeable difference in growth of emerging markets versus growth of the developed world. This is partly due to domestic demand growth, which has recently been much stronger in emerging markets relative to their history for some time. We believe that this can be an advantage, especially during the current global downturn. In the quarters to come, we feel that the gap between the emerging and developed world will become more and more noticeable to investors, as we do not expect significant economic growth in the developed world, but do expect emerging markets to increasingly rely on domestic demand to be an important driver of growth (though slightly muted) in the emerging economies.

Over the past decade, there has been high credit growth in parts of Western Europe, Ireland, Spain, the Netherlands, and especially Iceland. Emerging markets, on the other hand, have experienced relatively low credit growth, though there are exceptions in the Baltics (Latvia, Estonia, Lithuania) and in Bulgaria, the Ukraine, and Kazakhstan, as these countries were hurt by the devaluation of their currencies, which increased the value of their hard-currency liabilities. However, most emerging markets, and in particular the four major economies (Brazil, Russia, India, and China), are currently in a good standing, thanks to a combination of very modest or even negative credit growth, low debt/GDP ratios, high domestic savings, high foreign exchange reserves, and better current accounts, all of which help to cover short-term external debt payments. This is, obviously, a dramatic change versus the late 1990s, when many emerging countries did not have this type of savings to defend themselves during periods of economic distress; it is also one of the reasons why we believe developing markets will fare well over the long term.

During 2008, a huge unwinding of the carry trade occurred, which caused many emerging market currencies to decrease significantly. We feel that, following the recent drop, these currencies are relatively attractive at this stage; we anticipate fairly moderate appreciation over the coming years for many emerging market currencies, even if at a controlled pace to maintain competitiveness.

In conclusion, as we have consistently reminded investors for quite some time, in our view one size does not fit all within the emerging markets asset class. We believe that, in the future, emerging markets will be viewed as a style-sensitive, complex group of asset classes. We challenge investors to consider the versatility of emerging market approaches; however, we caution that emerging markets are still quite volatile, and remind that they might not be an option for all investors.

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

NOTES:

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1 Source: Bloomberg

2 Source: Bloomberg

3 Source: Bloomberg

4 This is an update from our Investment Research paper "The Crumbling Foundation of U.S. House Prices: May 2009 Update," available at http://www.lazardnet.com/lam/us/literature_research.shtml.

5 Source: Bloomberg

6 Source: Credit Suisse

7 National Income and Product Accounts – Bureau of Economic Analysis

8 Source: CLSA Securities

9 As of 31 May 2009. Source: Lazard Asset Management, MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.