LAZARD

2009Q3 **Outlook**

U.S. EQUITY / JULY 2009

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.

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NOTES:

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

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