



MARKET COMMENTARY • JULY 2009

OUTLOOK

During the last month, we've seen continued improvement in financial conditions — reflecting investors' increased willingness to take risk. We expect this to help support an economic recovery through bolstered corporate and consumer confidence. World stock markets have sustained their rally from the March lows, and risk taking also has continued apace in the credit markets, with both investment-grade and high-yield spreads having contracted measurably.

Recent data on the U.S. economy shows signs of steady, but not flashy, progress toward growth. The new orders component of the Institute for Supply Management survey moved into expansion territory with its 51.1 reading, and, when compared with plunging inventory levels, indicates the potential for an inventory-led bounce in production. The early signs of improvement in the labor markets, hidden behind the headline-grabbing national unemployment rate of 9.4%, show that initial unemployment claims reached a high at the end of March and have been falling since. This is harmonious with the pattern typically seen at the end of a recession.

The recovery in emerging markets growth continued to set the pace globally, followed by developed Asia, where stimulus has helped the typically sluggish Japanese economy rebound from a dramatic falloff in production. Developed Europe remains the global laggard, with modest growth expectations being held back by political structure and inflation concerns. We continue to think the emerging market economies will lead the global economy out of recession, followed by the United States, developed Asia and Europe.

Global sovereign fixed income markets sold off sharply during last month, reflecting a return to risk taking, reflation concerns and looming supply issues. We think this sell-off has mostly run its course, and bond prices should stabilize as investors discount the slow economic recovery and resulting restrained inflation outcome that we expect. This backup in yields likely is a typical end-of-recession phenomenon, in which rates have historically jumped sharply at the first signs of an economic recovery.

U.S. EQUITY

- U.S. stock markets have continued to be led by companies that potentially will benefit the most from an economic recovery.
- Stocks have rallied strongly from the March lows, leaving valuations less attractive but still comparing favorably to Treasury yields.

The U.S. stock market recovery during the last three months — led by an 80% bounce in financial stocks (putting them at a 0% gain year-to-date!) — has the hallmarks of a classic cyclical recovery. Cyclical stocks have been strong performers, while defensive stocks have lagged.

Continued improvement in the credit markets likely will be a necessary contributor to further stock market gains, but the focus is increasingly on the durability of an economic recovery. We've recently boosted exposure to U.S. equities as our confidence on both these fronts has improved, but further conviction in sustainable economic growth will likely be required to continue down this path.

EAFE AND EMERGING MARKETS

- Emerging markets are leading the recovery in global earnings estimate revisions.
- Although Europe looks set to lag a global recovery, Japan's growth appears ready to bounce back more strongly.

It's become the consensus view that emerging markets are best positioned to lead a global recovery, as the stocks have rallied the most, and earnings estimates now reflect these views. Still, we think the valuation of emerging markets stocks remains attractive, and the fundamentals look set to continue improving.

We believe the Europe, Africa and the Far East (EAFE) index of developed country stocks will lag global markets because of the regions' more difficult economic outlook. Growth in EAFE looks set to trail its global counterparts, as European policy makers are proving less responsive than their Japanese counterparts in addressing cyclical and financial market problems.

FIXED INCOME

- Steepening Treasury curve reflects strong crosscurrents in the economy and markets.
- Supply of government debt likely will remain heavy indefinitely.

The recent trend of better-than-feared economic data was a key factor behind the earlier steepening of the Treasury curve. More recent pressure on longer rates reflects growing worries that the government's huge fundraising requirements might overwhelm demand from the bond markets. This worry has investors paying close attention to the Treasury's ongoing auction results, especially details regarding who is buying. Also, off and on concerns about the budget deficit, the dollar and inflation have moved more firmly onto investors' radar screens. Still, fundamental factors in support of a steeper curve (such as signs of rebounding growth or rising inflation) are neither evident nor on the near horizon. However, unless the economic data deteriorates anew, these concerns are likely to persist.

HIGH YIELD

- High yield risk premiums narrowed even as defaults rose.
- New deal activity remained strong, especially for better quality issuers.

High yield bonds continued to benefit from the rebound in investors' risk appetites. Solid demand from both retail and institutional buyers has produced a multimonth trend of positive

asset flows, which is helping ramp up new-deal activity in both the United States and Europe. On the surface, investors seem content to look past evidence and expectations of increasing issuer defaults, focusing instead on constructive technicals and signs the economic deterioration is slowing. The strong performance of the broad high yield market indexes (with spreads moving just below 10% for the first time since October 2008) masks ongoing differentiation among issuers. This tremendous spread tightening reflects much of the improvement we have been expecting, so we removed our tactical overweight on high yield this month.

GLOBAL REAL ESTATE

- As private real estate begins to refinance debt in 2010 to 2012, we believe attractive investment opportunities for public REITs should surface.
- Current fundamental challenges leave the near-term investment outlook cloudy.

Global real estate is an economically sensitive asset class where prices are heavily influenced by the cost of capital. The downturn in real estate was driven by high leverage and concerns about access to capital. Publicly traded REITs successfully reduced leverage this year through \$14 billion in equity issuance, triggering a 30% plus rebound in prices since the March 2009 lows. However, underlying real estate fundamentals remain weak. Debt-financed private real estate remains overly leveraged, so a sustained recovery in REIT prices is unlikely. With many private mortgages larger than the corresponding properties' values, distressed investment opportunities likely will be available for well-capitalized public market REITs.

HEDGE FUNDS

- Hedge funds generated strong returns during the healthy market environment last month.
- Longer term, hedge fund performance tends to be most valued in flat to down markets.

After a strong April, hedge funds seemed to have the wind at their backs in May. Investors should be wary of expecting the magnitude of this performance to persist. A look at the HFRI Equity Hedge Index, comprising long/short equity hedge funds, helps illustrate why. This index beat the S&P 500 by 150 bps in May, only the third month during the past two years that it has outperformed the S&P 500 when the S&P 500 was positive. However, during the same period, annualized returns to the index have outperformed the S&P 500 by almost 13% with significantly lower volatility (13.5% vs. 21.9%). Long-term outperformance historically has come from beating the S&P 500 in flat and down markets, not generating big returns in "up" markets.

COMMODITIES

- We expect commodities to continue to gain favor as investors position themselves for an emerging-markets-led recovery and also favor hard assets.
- The global downturn has sharply reduced investment in productive capacity, which should lead to tighter supplies during the next upturn.

Price increases across the commodity complex in the last quarter have been broad-based. We believe pre-buying by the Chinese has helped fuel this rally and could lead to a pause near term.

Producers in both the energy and metals industries have slashed production during the global recession, making it that much tougher to increase supply when demand growth resumes. This longer-term dynamic has led us to increase again this month our tactical allocation to commodities.

CONCLUSION

This month, we made several changes in our tactical asset allocation policy to reflect the fast-moving markets. We've reduced the allocation to high yield by 2.5%, returning it to its strategic level, because we feel valuations are less attractive. We also removed the overweight recommendation of 1.25% on short/intermediate bonds, which was implemented in response to an extraordinary increase in municipal bond yields relative to risk-free Treasuries — this has now returned to near normal.

The proceeds were invested in commodities (2%) and equities (1.75%), predominantly U.S. large cap. We favor commodities as a beneficiary of emerging market growth and as an inflation hedge. We've now increased U.S. large cap equities back to their strategic norm allocation, as we find the valuation more attractive than high yield bonds.

We've made an unusually large number of tactical asset allocation policy changes this year in reaction to the atypical economic and financial market conditions. Going forward, we'll be focusing increasingly on the economic outlook, along with global central bank plans to remove their extraordinary levels of liquidity support without derailing the economic recovery or fostering unacceptable levels of inflation.

Commentary provided by Jim McDonald