



## MARKET COMMENTARY • AUGUST 2009

### OUTLOOK

After a strong advance in worldwide equity markets from early March through mid-June, stocks and other risk assets experienced a four-week correction before regaining strength in mid-July. Reflecting the selling of riskier assets, the yield on the 10-year Treasury fell from an intra-day peak of 4% to around 3.65% currently. The sell-off in risk assets has been fairly orderly, with the Chicago Board Option Exchange's measure of volatility (the VIX index) and the dollar relatively unchanged. So what led to this retreat from risk, and how serious are the threats to expectations for a sustainable economic recovery starting later this year?

The traditional aspects of business cycle analysis still are generally supportive of an impending economic upturn. Leading economic indicators increased sequentially during the last three months, a constructive sign for growth.

The Institute for Supply Management (ISM) Manufacturing Index is exhibiting a similar pattern, though June new orders did fall back. Manufacturers slashed production during the past nine months, setting the stage for a production bounce with a continued improvement in orders. We continue to expect emerging markets to lead a global rebound, and evidence, such as May trade data, increasingly supports this view.

But we're not in your garden variety recession and recovery scenario. Severe financial crises tend to generate long recovery periods, and the flow of economic data will not be smooth. A unique aspect of this financial crisis is the amount of credit creation that occurred outside of traditional deposit-taking institutions—and this capacity must be rebuilt before recovery can take a firm hold. The current travails of CIT Group, a significant lender to small businesses, are the most recent reminder that the credit markets have not yet fully recovered. We still believe the economy emerging from the current crisis will be a slower growth economy, held back by higher household savings, a tighter credit environment and a need to source growth increasingly through exports.

### U.S. EQUITY

- June market movements were more subdued as overall volatility fell.
- Earnings revisions turned modestly positive due to corporate cost cutting.

Although economic data and the credit crisis have shown mixed progress, the U.S. stock market has been less volatile. Financial stocks have shown strength, and we're seeing some evidence of a bottoming housing sector. A period of consolidation and repair will be helpful and welcomed.

Political considerations will be important in the coming months, including the direction of health care reform; the task of addressing the mounting budget deficits at federal, state and local levels; clarity regarding Ben Bernanke's reappointment as Chairman of the Federal Reserve; and the

future of the government-owned companies and industries. Within U.S. equities, we continue to favor larger-capitalization companies because of their better access to credit and greater exposure to emerging market growth.

## **EAFE AND EMERGING MARKETS**

- Economies with the biggest industrial production drops are bouncing highest.
- Chinese car sales have reached U.S. levels, a meaningful secular signpost.

The downturn in industrial production that began in the fall of 2008 is reversing, with those economies hardest hit bouncing back the strongest. Emerging Asian economies, such as Korea, Singapore and Taiwan, are experiencing 20% to 40% jumps in industrial production, after experiencing similar downturns. This phenomenon also is holding, to a lesser degree, in major developed economies like Japan and Germany.

Evidence of the secular transition of global growth continues to mount. Chinese growth for the second quarter surprised on the upside, driven by domestic demand. Chinese vehicle sales recently surpassed U.S. levels, further evidence of the growing importance of the emerging market consumer. While emerging market stocks will be subject to periods of over- and under-exuberance, the long-term economic growth picture remains compelling.

## **FIXED INCOME**

- A decline in Treasury rates reflects both fundamental and technical developments.
- We expect no letup in supply of government debt.

The well-received Treasury refunding this month caught most investors by surprise as the “playbook” during the past several months has been for the dealers to cheapen the market ahead of the auctions and then drive prices higher afterward. Instead, fundamentals ruled the day as June’s weaker-than-expected labor report delayed expectations for an economic recovery.

In addition, recent changes in the repurchase agreement market, charging punitive fees for failing to return securities on time, created additional demand for Treasury debt. Lower Treasury rates are a welcome sign for the residential mortgage market. So, somewhat perversely, the downward move in Treasury yields has improved the economy’s recovery prospects even as it suggests the timing of a recovery has been delayed.

## **HIGH YIELD**

- High yield risk premiums widened modestly.
- The flow of new deals slowed.

High yield bonds reached an inflection point after experiencing their biggest rally in history. The Barclays Capital U.S. Corporate High-Yield 2% Issuer Cap Index tightened from 1,937 basis

points (bps) in December to 918 bps in mid-June. Cash flows surged into high yield bonds in early 2009 after investors concluded that the government's aggressive actions would prevent a systemic meltdown of the economy. However, the rally appears to have run its course.

Since mid-June, high yield spreads widened by almost 60 bps. The rising default rate on high yield debt was well anticipated, but falling confidence in the economy's recovery prospects and a slowdown in new high yield deals were not as expected. The high yield market now has moved to a point where fundamentals (credit quality and the economy) likely will drive future performance.

## **GLOBAL REAL ESTATE**

- Refinancings and valuations drive REIT rally.
- We expect increasing divergence between public and private real estate.

Private real estate firms face headwinds as an expected \$1.2 trillion of private real estate loans mature during the next three years, and the commercial mortgage backed securities market looks bleak.

Public REITs are better situated as they have successfully raised equity capital and are well positioned to acquire distressed private real estate properties at attractive valuations. Several new REITs have been listed from well-known strategic investors to target these opportunities. Near term fundamentals remain cloudy because of declining demand, and that keeps us cautious toward this asset class. But current valuations will become increasingly tempting to long-term value investors.

## **HEDGE FUNDS**

- Hedge fund returns moderated in June.
- Last year's losing strategies appear to be this year's winners.

Equity and fixed income markets stabilized in June, following nearly three months of exceptionally strong performance, and hedge funds largely followed suit. Lurking beneath hedge funds' overall steady performance is persistently strong performance among some of last fall's most serious laggards. Convertible bond arbitrage, relative value strategies and emerging markets managers – all of which performed badly in the latter part of 2008 because of significant dislocations in historical asset relationships and/or severe risk aversion – have enjoyed strong returns this year. As credit markets stabilize, and volatility and risk aversion become more subdued, these managers have been able to add value through their traditional investment processes.

## COMMODITIES

- Commodity prices followed the broad markets lower as markets consolidated.
- Commodities remain an attractive inflation and currency hedge.

Commodities tend to perform best when investors discount an economic recovery. China's aggressive buying of industrial metals early this year, ahead of their annual price negotiations, probably accelerated some of this performance. The recent softening of commodity shipping rates indicates that we may see a pause in commodity demand growth as inventory is digested.

Oil prices continue to be influenced first by U.S. growth expectations, then by concerns about inflation and the U.S. dollar. Fundamentally, there is a current oversupply of oil. But we think renewed global demand, alongside weak recent investment, will lead to higher prices longer term. Even though near-term supply issues may overhang broad commodity prices, we wouldn't be too tactical in approaching this asset class as it moves quickly and remains an attractive inflation and currency hedge.

## CONCLUSION

So what near-term indicators will we be watching closely during the next several months? Guidance from second-quarter earnings reports will help determine whether the softness in June's ISM orders was a one-time event. Weekly unemployment claims need to continue demonstrating the pace of improvement shown during the last three months. Finally, investors want clear signs that policy developments from Washington will restore predictability to the capital markets.

We made no changes in our tactical asset allocations during the last month. Overall, we remain somewhat defensively positioned with a focus toward those assets benefiting from the recovery in emerging markets. We continue to believe government involvement has mitigated the risk of another substantial financial system meltdown, but also has added a new political element to the investing process. Our base case remains an inventory-led production bounce in the economy in the fourth quarter of this year, but the recovery's strength and durability in 2010 and beyond remain the wild card.

*Commentary provided by Jim McDonald*