



MARKET COMMENTARY • OCTOBER 2009

OUTLOOK

The strength of the rally in global financial markets during the last six months rests on the foundation of the successful policy actions to date and the building economic recovery. The monetary policy measures — massive in the United States, smaller but still measurable in Europe and Asia — have led to a significant improvement in financial conditions. These improved financial conditions are, in turn, facilitating an economic recovery that is currently being driven by a global inventory cycle. Both these conditions are still somewhat fragile, however, because of their dependence on government involvement and their vulnerability to an untimely removal of this support. So what will the financial and economic landscape look like during the transition to the second phase of this recovery, where governmental support is meaningfully diminished and end demand needs to become self-sustaining?

Two of the important, and successful, support programs introduced by the U.S. government are nearing their end, and we think the markets are ready for this transition. The Money Market Investor Funding Facility and the Temporary Liquidity Guarantee Program, which helped restore confidence in money market mutual funds and allowed troubled financial firms to refinance their public debt, appear set to expire this quarter. To be sure, ending these programs is a small step in unwinding the multi-trillion dollar Federal Reserve and Treasury liquidity support programs, but it's clearly a sign of the improvement in credit market functioning and a healthy return to investor risk taking.

As liquidity support programs are removed, focus will increasingly turn toward traditional monetary policy. We expect the Fed to remain accommodative for an extended period, as low inflationary pressures allow it to delay raising rates until the economic recovery is strong enough to sustain them. Other central banks are likely to be less patient. As economies less hurt by the global financial crisis start to tighten financial conditions, their higher interest rates likely will support their currencies and pressure the currencies of others.

U.S. EQUITY

- August continued July's positive momentum with markets finishing up, driven by financials and higher-risk stocks.
- Performance has been fueled by attractive valuations, improving economic data and positive earnings revisions.

Investor appetite for risk continued to drive positive market performance. Low-risk, high-quality stocks continue to lag their riskier peers, in contrast to what worked last year. Volatility is close to 52-week lows, which may suggest risk aversion is closer to normal levels and that the appetite for low-quality stocks will subside.

More positive global growth and a lower dollar should benefit companies with exposure to emerging markets and OECD countries. Also, the thawing capital markets and low cost of capital may set the stage for an M&A recovery, which could provide support for continued market appreciation.

EAFE AND EMERGING MARKETS

- European equities led the rally in developed market equities.
- The revaluation of emerging market equities is justified by a lower risk profile.

The surprising improvement in Europe's growth outlook led to the outperformance of that region during the last month. The euro's continued strength, supported by a slightly more hawkish European Central Bank, could eventually moderate the pace of growth in export-oriented countries like Germany. Japanese equities could continue to tread water as financial markets assess the implications of the country's first real change in power in the last half-century.

Emerging market equities have jumped nearly 50% this year, as the global recovery started in these economies and looks to be more sustainable. Despite this appreciation, the valuation of emerging market stocks relative to world equities remains fair, reflecting the realization of their improved financial condition and lower risk profile.

FIXED INCOME

- M&A activity is on the upswing, aided by debt financing.
- Demand for credit investments remains strong.

Opportunistic companies are taking advantage of the challenging economic environment, still reasonable equity valuation levels and attractive debt financing terms to launch a series of M&A deals. Recent announcements include Baker Hughes purchasing BJ Services, Disney buying Marvel Entertainment and Kraft's hostile bid for Cadbury. The diverse mix of industries involved, as well as the pushback and positioning strategies engaged in by many of the target companies, are all signs that the budding recovery continues to advance. With bank lending still mostly in hibernation, the ongoing ability of high-quality companies to readily access financing in the public debt markets is a key support to the M&A mini surge. Demand for investment-grade credit remains robust as investors continue to take on increased risk by allocating away from low yielding money market investments.

GLOBAL REAL ESTATE

- Real estate investment trusts (REITs) continue to outperform the broader equity markets.
- European real estate securities led performance during the month of August.

Commercial real estate loan delinquencies, a measure of distress, increased 16% from last month to \$11.2 billion. Despite this negative news, commercial financing REITs were the strongest

performing sector in August. This move is tied to the recent news that 10 mortgage REITs have filed plans to raise almost \$5 billion to invest in distressed real estate debt.

Real estate transaction volume increased in the second quarter, but still remains less than half of what it was in the first half of 2008. Even though there has been some news of U.S. REITs acquiring properties, most remain cautious and haven't stepped back into the market. Activity is expected to pick up in 2010 when fundamentals may begin to stabilize.

COMMODITIES

- Aluminum prices, as a proxy for industrial production, have begun rising.
- Oil prices have plateaued after significant financial-hedge related buying.

Aluminum is the metal most levered to auto production and global growth, and has seen pricing start to increase as inventories stabilize. Concern about falling commodities demand after the Chinese pre-buying of this spring is receding as global growth forecasts rise. Investor interest in commodities as a hedge against U.S. dollar weakness remains high and is an important component of analyzing commodity prices and equities.

After doubling to \$70 per barrel since February, oil prices remained relatively unchanged during the last month. U.S. inventories of crude oil remain high, but are starting to be worked down. And both the International Energy Agency and OPEC have recently marginally raised demand forecasts. As the ferocity of the move in oil earlier in the year demonstrates, commodity price action can be violent (in both directions).

CONCLUSION

So how will the global economy and markets handle the removal of stimulus and transition to a new, balanced, growth picture? The initial signs of financial market repair are encouraging — but in the United States, at least, there is still considerable dependence on the government (for example, Fannie Mae, Freddie Mac, General Motors, AIG and Citi). Economic growth is enjoying a strong bounce as improvement in new orders is leading to increased production plans — with the strongest growth in Asia and, surprisingly, better than expected growth in Western Europe.

Even though the global recovery is underway, the strength and duration aren't clear. What does seem clear is that the countries and regions that went into the crisis with the best fiscal positions are most likely to emerge the strongest in the rebound. In the wake of this, participation in global markets for growth and currency reasons looks increasingly attractive. In support of this, we have again this month increased our tactical exposure to emerging market equities.

Commentary provided by Jim McDonald