



MARKET COMMENTARY • JANUARY 2010

OUTLOOK

As we look to the start of the new year, our thoughts are on the pace of the global economic rebound and the state of public finances. In our analysis of the relative growth trajectories of the major developed economies, we have upgraded our view of the U.S. economy — a stance we first considered last month. The November payroll report revealed that the economy shed 11,000 jobs. While still well short of the minimum 100,000 new jobs needed monthly to reduce the unemployment rate in a sustainable fashion, this is a continued step in the right direction. Evidence from the transportation sector indicates a continued pickup in business, and November retail sales also were a positive surprise. To be fair, not all the economic data has shown these gains, but on balance, we think the outlook is improving.

In contrast to the reports from the United States, recent data from Japan and Europe has been less inspiring. Japanese gross domestic product (GDP) growth for the third quarter has been revised from an initial report of 4.8% annualized growth to just 1.3%, due to a significant reduction in estimated corporate capital spending. In Europe, weak industrial production data for the eurozone and soft German order and output data for October give some pause to the generally improving growth outlook. With German exports having recovered only one-third of the volume lost during the recession, Europe's largest economy still has room to expand, but the path may be more uneven than previously thought.

As we move further from the nadir of the global stock markets reached last March, we are increasingly focused on the financial repair bill left behind. This sovereign credit issue has been exemplified by the recent travails of Dubai and Greece, but is also of great discussion in the United Kingdom, United States, Spain and Ireland. We think the path to repair will start with governmental budget restraint, as Ireland has proposed, and from there will be dependent on continued global economic growth.

U.S. EQUITY

- A constructive jobs report and strong retail sales improve the outlook.
- The Fed will wait for more evidence before initiating tightening cycle.

The November jobs report came in materially better than consensus estimates, most notably with the sharp reduction in loss of jobs. This report, along with robust retail sales and other generally positive economic data, prompted a reassessment of our base case expectation for U.S. growth from one that could disappoint to one that may positively surprise. Furthermore, we think the Fed will maintain an accommodative monetary policy until it's certain the nascent recovery has legs — thus continuing the favorable environment for U.S. equities. This constructive expectation for growth is predicated, in part, on increased emerging market demand and comes

even as credit remains a concern for companies lacking diverse revenue streams. Therefore, larger companies are expected to outperform their smaller brethren.

EAFE AND EMERGING MARKETS

- The European Union and Japan are facing varied fiscal challenges.
- Emerging market growth continues to impress.

Years of fiscal profligacy are catching up with countries such as Greece, Ireland and Japan, and could lead to a more measured tightening cycle than central bankers would otherwise undertake. Meanwhile, growth in developed Europe and Japan may be losing some momentum of late, especially when compared with emerging markets and the United States.

Emerging market growth, which led the global economy out of its recession earlier this year, continues to generate headlines. Chinese industrial production growth in November is estimated at 19.2%, while increasing imports have led to a 53% reduction in China's trade surplus from a year ago. India, South Korea and Singapore joined China in generating greater than 10% GDP growth in the third quarter, and appear well positioned heading into 2010.

FIXED INCOME

- Risk measures remain subdued, despite recent flare-ups in Dubai and Greece.
- The global recovery is turning investor focus toward fiscal repair.

Risk assets of all types rallied strongly during most of 2009, reversing the dramatic flight to quality that took hold in the fourth quarter of 2008. Sovereign issuers benefited from this turnaround, as evidenced by the spread narrowing on the debt of weaker European countries. Recently, investors have begun to pay more attention to those countries with the largest budget deficits, specifically focusing on whether they are likely to develop a realistic plan and timeline for dealing with their fiscal stress. International investors are expecting these governments to unveil fiscal repair programs in 2010 that will put their balance sheets on a path to recovery. If this doesn't happen, investors are likely to see spreads start to widen for many more of these countries.

GLOBAL REAL ESTATE

- Year to date global real estate investment trusts (REITs) have returned more than 36%.
- Strong performance in U.S. REITs led performance for the global index.

November marked a critical reopening of the commercial mortgage-backed securities (CMBS) market. In mid-November, Developers Diversified, a U.S. shopping center REIT, successfully completed the sale of \$400 million of CMBS. This was also the first commercial mortgage deal sold under the Fed's Term Asset-Backed Securities Loan Facility program. Although this is only a small step on the path to recovery, demand for the deal was strong and pricing tighter than

expected, which is seen as a positive sign for the future. Investor sentiment remains cautious, however, as fundamentals continue to be weak and delinquencies and debt maturities remain an area of concern.

COMMODITIES

- Chinese infrastructure and auto production are driving commodity demand.
- Global oil markets remain well supplied.

The drivers of industrial metals prices continue to be the stunning growth of construction and auto production in China this year. With government stimulus geared toward real estate and infrastructure, floor space under construction in China was up 50% in November, a modest slowing from the 67% pace as of September. We continue to favor those markets where China is dependent on imports (iron ore, metallurgical coal and copper) and are more wary of those China can produce (including steel and aluminum).

Oil prices have been relatively well behaved of late, because U.S. inventories are stubbornly high and OPEC has been putting more oil on the market. We think the Saudis, as key swing producers, are pragmatic and don't want oil to move too high too fast and derail the global recovery.

CONCLUSION

As we get ready to welcome the new year, we expect the combination of broadly accommodative central banks and improving global growth to continue to support measured risk taking. Emerging market growth continues to be robust, with strong growth in major emerging economies beyond just the Chinese 800 pound gorilla.

We do see an improved relative growth outlook for the United States compared with developed Europe and Japan, and have increased our recommended tactical weighting in U.S. large cap equities at the expense of the EAFE allocation. The risk to our moderate overweight to risk remains an early tightening by central bankers — if it is reactive to an increase in inflation expectations, it could be poorly received by the markets. We continue to think a portfolio overweighted toward emerging markets best positions investors for both the potential continuation of near-term growth trends and the anticipated long-term rebalancing in global output.

Commentary provided by Jim McDonald