



MARKET COMMENTARY • MARCH 2010

OUTLOOK

During the last month, global equity markets have experienced corrections of varying magnitudes — ranging from 9% in the United States to 13% in Europe. This has occurred during a period of generally favorable economic data and corporate profit reports. So is the market discounting a deterioration in future economic data, or have other factors led to this pullback? We think the drop in investor risk appetite is primarily tied to two developments — China’s tightening of monetary policy and the Greek debt crisis. Chinese authorities recently increased their banks’ required reserves for the second time this year, with the first increase helping to end the market rally in mid-January. Meanwhile, the state of the Greek debt crisis can be well summarized by its finance minister’s recent comparison of the Greek economy to the Titanic.

China’s actions to cool its economic growth come after a year of tremendous fiscal stimulus that has led to money supply growth of nearly 30% at its peak last November. This has spawned concern about overbuilding in the commercial real estate market. Authorities also must be concerned about the uptick in inflation over the last six months. By targeting a reduction in money supply growth to 17%, Chinese officials expect to slow the breakneck pace of recent growth. Even though this is not a foregone conclusion, we expect them to be successful in moderating growth while maintaining their expansion.

The European growth outlook is more disappointing. European fourth-quarter gross domestic product (GDP) growth of just 0.4% (annualized) pales against the 4.6% registered in Japan, 5.7% in the United States or 9.9% in China. We think this weaker growth outlook, compounded by the ongoing efforts to convince the markets about the Greek financial stability plan, will lead the European Central Bank to maintain accommodative monetary policy for much of 2010. We expect the U.S. Federal Reserve to show similar restraint as it seeks to mitigate the risk of economic downturn through premature monetary tightening.

U.S. EQUITY

- Risk aversion caused a pullback in the rally that began last March.
- Corporate earnings and revenue growth continued to progress, reflecting the gradually improving global economy.

Since mid-January, worry and volatility returned across U.S. markets, prompting a correction. The S&P 500 retreated 9% from its mid-month high. Underlying the concerns are the potential populist policy implications of Senator Scott Brown’s victory in Massachusetts; European sovereign concerns, with a current focus on Greece; and signs of Chinese monetary policy tightening. Nonetheless, fourth-quarter earnings were encouraging for U.S. companies, with profits continuing to climb quarter-over-quarter and improving revenue growth. Despite the significant market rise since March 2009, U.S. equities remain inexpensive by historical

standards, particularly in the context of the current interest rate environment. As the global recovery continues, despite concerns about Europe, shares should benefit.

EAFE & EMERGING MARKETS

- Credit concerns and weaker growth pressure the Eurozone.
- Emerging market growth remains robust, benefiting suppliers like Japan.

European stock markets have lagged their global peers during the recent correction due to the combination of growth and credit concerns. Fourth-quarter growth for Europe totaled just 0.4% (annualized), with 3% growth in France being offset by near 0% growth in Germany and outright contraction in Italy and Spain. Countries in Central and Eastern Europe struggled even more, raising investor concerns about credit issues beyond Greece.

The focus in emerging markets has moved beyond the pace of the recovery to the tightening intentions of central banks ranging from Australia to China to India. Resource-intensive economies that benefit from emerging market growth, like Australia and Canada, are seeing robust employment rebounds. Our constructive outlook for growth keeps us positive on emerging markets, but with a watchful eye on financial conditions.

FIXED INCOME

- Steady industrials performance supports the economic recovery thesis.
- The outlook for financial issuers remains cloudy.

While recent economic data and earnings results indicate that the economic recovery is proceeding, increased risk aversion has recently boosted investment-grade credit spreads. Within the industrial sector, signs of stability and strength remain evident. Investor focus is shifting from controlling costs and undertaking mergers or acquisitions to looking for top-line growth, as better positioned firms benefit from strengthened market share and pricing power. The trend of earnings results in the financial sector is less positive. Despite the support to earnings from the still record low interest rates and 2009's rebound in asset prices, stiff headwinds continue on both the business and regulatory fronts. Adding to the clouded outlook for financials is the recent flare-up among sovereign issuers, which has triggered a new focus on the risk of credit contagion.

GLOBAL REAL ESTATE

- Global real estate investment trusts (REITs) declined by nearly 6% in January.
- U.S. REITs fell more than 5%, driven by underperformance in regional malls.

More than \$55 billion of equity was raised by real estate companies globally in 2009. This contributed to strong performance for the year, but will exacerbate earnings declines, as many issuers raised equity at meaningful discounts to the underlying real estate values. Private real estate values have declined by 30% since the market peak, excluding the effect of leverage. As

evidenced in January, strong performance in global REITs likely is not sustainable, as implied listed market cap rates have come down by 1.30% over the last 12 months, bringing them in line with direct market cap rates of 6.2%. We believe the narrowing of this valuation gap and continued deterioration of property fundamentals will limit global REIT returns in the near term.

COMMODITIES

- Copper prices reflect the leverage of commodities to the global growth trade.
- Supply and demand for oil should tighten as the global economy grows.

Incited by the mid-January tightening of monetary conditions in China, commodities have shown their stripes as a leveraged play on the global economy. Copper prices declined 18% on worries about reduced Chinese infrastructure demand. (China represented more than 40% of global copper demand in the first nine months of 2009.) As stock markets regained some footing by mid-February, copper prices rebounded more than 10%. Demand for energy commodities, particularly oil, should rebound with the global economy, but there remain few signs of new supply on the way. Big historical producers, such as Mexico, Venezuela and Russia, appear to have seen their best days, while new supply from Brazil and Iraq looks slow to appear. The long-term bias in oil prices, like many other commodities, appears to remain to the upside.

CONCLUSION

Risk assets, particularly equities and corporate bonds, have enjoyed significant appreciation from the market lows set last March. Many of these gains can be attributed to the success of global central banks in convincing the markets, through substantial policy initiatives, that a second Great Depression could be avoided. These same central bankers must now engineer, over time, the removal of much of this stimulus while the global economy still faces a large debt overhang with the attendant political and financial risks. In this environment, the gains in risk assets going forward will be more muted and subject to policy error. The risks tied to the success of Chinese monetary tightening and resolution of the Greek debt problems have surpassed the risk of a premature hike of interest rates by the Fed. Other than these potential (but low likelihood) disruptions, we maintain a constructive outlook for risk assets.

Commentary provided by Jim McDonald