

July 2010

# Outlook for the United States

Entering the second quarter, we saw hopeful signs of economic recovery in the United States, which signaled the potential for an upside surprise to U.S. GDP in 2010. At the same time, we cautioned that the relative strength in 2010 could be followed by disappointment in 2011, as fiscal tightening in the form of tax increases and spending cuts at both the federal and state levels supersedes stimulus.

Exogenous factors weighed on U.S. prospects as the quarter progressed, causing the near-term outlook to dim. The market continued to show disbelief that the problems in the Eurozone had been solved, as the pricing on Greek credit default swaps hit new record highs near the end of the quarter. The fears emanating from Europe coincided with steps by China to dampen speculation in its property market. These demand-depressing situations reduced corporate enthusiasm for inventory re-stocking and re-hiring of employees relative to what we had hoped to see.

In spite of these headwinds, we are seeing diverging trends in various sectors.

- **Positive:** Technology and industrial companies are reporting increased demand for their products, in some cases at an accelerating pace.
- **Negative:** Materials companies suffered as the macro concerns noted above decreased willingness to stockpile commodities, decreasing demand. Consumer companies are putting up erratic numbers that depend largely on the demographic of their respective customer bases.
- **Idiosyncratic/Government-driven:** Illustrating one of our secular themes of the reversal of decades of deregulation (aka Reaganism/Thatcherism), government intervention is the primary story in the health care, energy, and financials sectors, representing a sizable percentage of U.S. GDP.

We have noted consistently in the past that we believe the United States is entering a multi-year era in which the shape of the economy will evolve to be less dependent on providers and users of leverage. This transition will involve a significant, though perhaps glacial, migration of capital within and among industries. Capital typically moves either in response to, or in anticipation of, changes in demand. This quarter, we are seeing exactly the types of demand shifts that should be expected in the aftermath of the era of disinflation and leverage. We do not expect the next secular trend to be obvious or to progress in a linear fashion, but we do believe we are seeing early signs of movement.

Below is a review of six key sectors and an update on our views on deleveraging, housing, and deflation/inflation.

## Technology

- **Demand growth:** We continue to see solid results from the majority of technology companies, as demand improves and the supply chain adjusts to it. It remains to be seen if the impact of re-stocking is masking any macro weakness. This is one of the biggest uncertainties heading into the second half of 2010.
- **Vendor consolidation:** It is our view that larger solution-based providers are still taking market share, as buyers consolidate the number of vendors they are using. This trend is unlikely to let up, and, as a result, we believe we will see these providers execute better than niche or smaller vendors.
- **M&A:** Inorganic growth remains a key theme. Many companies are still generating healthy cash flow and building on their net cash positions. As a result, many are still looking to broaden their capabilities and leverage their scale to drive both revenue growth and increasing returns.

## Industrials/Materials

- **Industrials:** “What you can’t (yet) see can hurt you” is one way to describe the second quarter for industrial stocks, as almost all order, sales, and production data remained very strong (in many cases trends are accelerating). The data points we track for industrials include company monthly sales and order trends, releases from distributors, and industry data such as rail traffic, truck tonnage, and air freight movements. We also monitor macroeconomic data such as Institute for Supply Management statistics, industrial production, inventory levels, and durable goods orders. Despite all of these indicators remaining positive, concerns about the implications of the sovereign debt situation, the weak euro (and strong U.S. dollar), and issues in China have resulted in significant multiple contraction in industrial stocks, as the term “double dip” has crept back into investors’ vocabularies.
- **Materials:** The picture here is more mixed. The second quarter can be described as “the trend is not your friend.” Commodity prices have come under pressure across the board due to concerns over the issues in Europe, government efforts to slow growth in China, and the appreciation in the U.S. dollar (which makes commodities more expensive in other currencies). These factors have resulted in lower commodity prices (metals, commodity chemicals, agricultural commodities), an unwillingness for distributors to build inventories, and pressure in some industry metrics such as the Baltic Dry Index, which seem to reinforce each other and have pressured material stocks.
- **Issues going forward:** We fully expect some headwinds from currency translation (not transaction to any large degree), pension expense (as interest rates have remained lower than expected), and a drag from weak economic conditions in Europe. However, it appears that a good deal of this is being factored into share prices, as a host of potentially negative issues have come to the forefront.
- **Considerations:** While perhaps of little comfort to the market until there is more certainty as to the macroeconomic outlook, the more we can identify “known” risks, the fewer “unknown” risks there are that can pop up and surprise us. It is true that many management teams and investors were caught by surprise by the events of 2008; however, as it stands today, it is hard to argue that investors are complacent. Considering that the most severe recession in decades (accompanied by a financial crisis) is so fresh in the minds of investors and management teams, the term “double dip” is again a matter of discussion, inventories remain low (we believe inventory liquidation will not be nearly as severe as it was during the crisis, even in a “double dip” recession scenario), and cost structures are in check.

## Consumer

- **Spending patterns:** With consumer spending accounting for close to 70% of U.S. GDP, we continue to scrutinize government and industry statistics on retail sales to identify clear signs of a recovery in private sector consumption. Alas, there is little consistency in the numbers month to month, and we have been able to identify only two relevant trends:
  - High-income consumers (defined as the 16% of total households with income >\$100,000) show a renewed willingness to spend on luxury goods and services.
  - Low-income consumers (defined as the 44% of total households with income <\$40,000) display extreme frugality.

Meanwhile, middle-income consumers (defined as the 40% of total households in between) demonstrate heightened volatility, as spending seems to vary month-by-month. Our read is that these consumers are hostage to their level of confidence, which in turn is heavily influenced by their view of employment prospects or job security. Thus, until wider employment trends show a consistent pick up, it is hard to see why overall consumer spending should show much improvement.<sup>1</sup>

- **Investment implications:** Given the circumspect outlook, we continue to focus on consumer stocks that have some combination of the following characteristics:
  - a) Strong brands in categories representing everyday goods and services
  - b) Self-help plans in place to fund additional brand support and market share growth in safe markets, while protecting margins
  - c) Levers of earnings growth other than fickle U.S. domestic demand (e.g., big synergies from successful recent acquisitions, or significant exposure to Latin American or Asian consumers)

Even while we seek these attributes, we avoid exposure to manufacturers and retailers of big-ticket items and to companies with poor cash flow that need regular access to banks or credit markets.

## Health Care

- **United States:** Attention in the health care sector turned to implementation of the reform signed into law late in March. The biopharmaceutical and medical device industries were among the first to provide cost estimates related to the reform, reducing the uncertainty surrounding the industries.
- **Europe:** Even while uncertainty was decreasing in some areas, it increased in others, specifically as it relates to the ramifications of European austerity moves on pricing and aggregate health care spending. Given the overwhelming degree to which governments provide health care in Europe, fiscal problems feed directly into pressure on pricing for biopharmaceutical products, especially generic and off-patent drugs. We have remained focused on those companies that we feel can weather this challenging environment by delivering innovative products and implementing operational offsets.
- **Research and Development:** Going forward, the productivity of the biopharmaceutical industry's R&D pipelines is the main variable. We are optimistic that several major new classes of therapeutic products will continue to progress towards commercialization, catalyzed by a number of important Phase 3 trial results over the next 12 months.

## Energy

- **Gulf of Mexico/Macondo:** The second quarter was dominated by the Macondo well blow-out and oil spill in the Gulf of Mexico, an event that began two months ago and is still unfolding today. The magnitude of this event and the likely fall-out remain uncertain, but we expect that this could fundamentally change how the industry does business in the United States and, perhaps, on a global scale.

In coming months, we will be looking for relief wells to bring some closure to the oil spill itself, even though clean-up efforts and liabilities will likely play out over a much longer period. We expect that the industry will face increased regulatory oversight, lengthier lease evaluation processes, and increased costs in deepwater Gulf of Mexico operations. Further, we see material risk of increased government regulation across a broad section of offshore and onshore energy activities. Jobs and energy security will be weighed against environmental concerns, the desire to shift to cleaner energy sources, and an appetite for increased taxation of energy producers.

- **Lateral implications:** Away from the Gulf of Mexico, onshore drilling remains surprisingly robust, as exploration and production companies continue to drill gas (and oil) shale plays despite weak natural gas prices. Operators are drilling for a number of reasons, including a need to hold current leases, an influx of cash from large multinational oil companies buying into joint ventures, and investors' expectations for volume growth.
- **Demand growth expectations:** Market expectations for global economic growth continue to fluctuate, with developments in China and Europe getting considerable attention of late. We saw evidence of improved U.S. demand for diesel in the second quarter, pointing to a recovery in commercial transportation and industrial demand. Gasoline demand trends are less encouraging and, coupled with recent weak housing data and high unemployment, continue to point to weak consumer spending.

## Financials

- **Regulatory reform:** This quarter brought the financial regulatory reform to its culmination with Congress preparing to vote on the conference resolution. Completing the legislation will reduce the uncertainty facing the sector and simplify our scenario analysis to some degree, as we will know crude parameters of what is and is not going to be allowed going forward.
- **Credit markets:** Public debt markets remain open, making it easier for financial institutions to sell bad assets than it was in the past. Specifically, we are hearing that there are increasing numbers of bad loans being sold from bank balance sheets, as prices have finally gotten high enough to avoid very large realized losses and hits to capital.
- **Macroeconomic fears:** Economic uncertainty is the major variable going forward. We have become more optimistic that we have seen the bottom in commercial real estate prices and are at or near the bottom in residential real estate prices. This optimism, however, is contingent on economic stabilization, which might be at risk due to events in Europe and at the federal and state fiscal levels.

## **Deleveraging**

The process of unwinding the excessive growth in leverage in the United States continued during the quarter. The Federal Reserve released the Flow of Funds report for the first quarter of 2010, showing that debt/GDP declined again by almost 600 basis points from the prior quarter. Debt as a percentage of GDP has now declined from 360% at the end of 2008 to 342.3%. The vast majority of the deleveraging occurred again in the financials sector, where debt/GDP has now declined from 120% to 102.5% since the first quarter of 2009. Consumer debt/GDP has also declined from a peak of 97.3% to 92.7% over the same period of time. Offsetting these improvements has been a stunning increase in government debt/GDP from 52% of GDP at the end of June 2008 to 72.2% this quarter.<sup>2</sup>

## **Housing**

While we became less negative over the last couple of quarters regarding the outlook for housing, recent data have made us question whether our decreased pessimism is misplaced. We are not ready to turn more negative yet, but have to admit that the demand for homes has surprised us to the downside, especially considering that 30-year fixed mortgages are at the lowest rates ever. That said, we have long discussed seasonal patterns in housing demand, and we are now seeing the data from the weakest part of the year.

## **Deflation/Inflation**

One thing we need to mention here is the risk of deflation. The newfound zeal for fiscal austerity in Europe, and the resurgence of similar sentiments in the United States, are coalescing with deleveraging and China's desire to cool demand to increase the risk of deflation. We have long said that we see the risk of deflation as being greater than that of inflation, both in terms of likelihood and severity were it to be sustained. We will continue to watch this topic. Sovereign yield curves clearly demonstrate a lack of fear of inflation, with the U.S. 2-year Government yield reaching a new low of only 60 basis points.<sup>3</sup> This is at least a 30+ year low in 2-year yields and reflects a belief that the U.S. Federal Reserve will keep short-term rates low, as well as the view that inflation risks are low.

At the same time, the yield curve remains steep for U.S. Government debt, with the spread between 2-year yields and 10-year yields at 234 basis points, near record-wide levels.<sup>4</sup> We interpret this spread not as fear of inflation, but rather as concern over the rapid increase in the ratio of debt to GDP at the sovereign level and the consequent increased risk of default.

## **Investment Implications**

As we survey the landscape, we see what appear to be conflicting signals regarding economic conditions. As mentioned above, the technology and industrials sectors appear resilient, while the consumer and materials industries are demonstrating questionable to weak trends. Energy, financials, and health care seem to be more focused on Washington D.C. than anything else these days, confirming our view that government intervention will be more prominent and sustained in the years ahead than it was over the course of the last two decades.

As we evaluate the investment opportunities in the United States against this macroeconomic backdrop, we continue to find very attractive opportunities to invest on behalf of our clients. Our scenario analyses consistently show that the companies with strong balance sheets, robust organic cash flow, and the resulting operational flexibility typically offer better reward and risk profiles than do their peers with lesser characteristics. We expect short-term ebbs and flows in actual stock price performance, but we believe strongly that these companies will deliver better results over time.

## Important Information

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1 Source: Barclays, U.S. Department of Commerce Bureau of Economic Analysis

2 As of 31 March 2010. Source: U.S. Federal Reserve, Bloomberg, U.S. Treasury Department, Social Security Administration.

3 As of 30 June 2010. Source: Bloomberg

4 As of 30 June 2010. Source: Bloomberg

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