

U.S. EQUITY / JANUARY 2010

## Examining an Evolving Economy

The events of 2009 have largely eliminated the short-term risk of systemic failure that we faced only a year ago. The adage of not fighting the U.S. Federal Reserve (the Fed) has clearly proven correct to date, as a near-zero interest rate policy, combined with a fiscal deficit equal to 10% of U.S. GDP, have transformed economic freefall to moderate growth quite quickly. The Fed and the U.S. Treasury Department bought over \$1.25 trillion of Agency mortgage-backed securities (MBS)<sup>1</sup> to drive mortgage rates in the United States down by 200 basis points from the highs of the mid-2008 to mid-2009 period.<sup>2</sup> The lower cost of borrowing reduced monthly payments by 20% per dollar of debt, leading house prices to stabilize and even increase by just over 5% from the lows, as measured by the S&P Case-Shiller 20 City Home Price Index (seasonally unadjusted). Savings rates in the United States rose from just above zero to almost 5% by the end of 2009.<sup>3</sup> Leverage began to decrease across the private sector even while government debt/GDP grew. Against this backdrop, equity markets recovered almost exactly half of the ground lost during the prior panic, while credit spreads narrowed to levels inside long-term averages.

Looking forward, we believe it is important to recognize that the degree of economic healing that many think has occurred is exaggerated by the remedies that have been applied by a range of government entities. In our view, before the economy will be healthy enough to sustain material longer-term growth, the United States will need to deleverage substantially. In the second and third quarters of 2009, debt outstanding in the United States fell from 362% of GDP to 355%, in spite of an increase of 560 basis points in government debt/GDP.<sup>4</sup> Even after this six-month decline, consumer and financial sector debt levels are literally multiples of levels experienced in prior generations. Given that we have exited the era of disinflation, in which interest rates declined for over 20 years, the potential for lower borrowing rates to sustain current levels of leverage (or even higher levels) is de minimis. As a result, we anticipate a multi-year, if not multi-decade, process in which the U.S. economy deleverages and recalibrates to a more sustainable composition. Moreover, recognizing that risk often merely changes form rather than disappears, we believe the key factors to watch have changed substantially as we enter the New Year.

As we indicated in the 2009 Q4 Outlook, it should be clear that no trend is a straight line. Rather, we expect to see intermittent periods, such as the third quarter of 2009, in which risk is embraced in the hope that cash flow will follow.<sup>5</sup> However, we believe that, for many companies, the cash flow will not come. Our investment focus is unchanged: We continue to invest in companies with robust organic cash flow, strong balance sheets, and the operational flexibility that results from these factors. To capitalize on the opportunities that lie ahead, we employ forward-looking, fundamental research that recognizes what can and cannot be estimated with precision and values companies under key scenarios related to these drivers.

### THE QUARTER BEHIND US

After enjoying five successive months of gains, house prices stalled in October. Credit spreads continued to narrow, but the U.S. Treasury yield curve steepened substantially. The process of unwinding extraordinary government intervention in some markets also began this quarter.

- House prices rose. Seasonally unadjusted home prices were up, as we expected, with the final reading delivered by Standard & Poor's on December 29 showing an increase for the period from August through October of 1.6%, a clear deceleration from the 3.6% gain from May to July. As we have noted before, we believe that lower mortgage rates, combined with foreclosure mitigation efforts and seasonality, drove the gain.
- Credit markets continued to recover, but the Treasury yield curve steepened. U.S. commercial mortgage-backed securities (CMBS) originations began again in the quarter with just under \$1.4 billion of new issuance. Full-year issuance totaled \$2.2 billion versus \$12.1 billion in 2008 and \$230.2 billion in 2007.<sup>6</sup> Clearly the market has not healed, but this is a start.

The spread of the Moody's Baa Corporate Credit Index over 10-year Treasuries narrowed 36 basis points in the quarter to 252 basis points. The yield on the Index, however, increased from 6.17% to 6.36%, as Treasury yields rose from 3.31% to 3.84%.<sup>7</sup>

The steepness of the Treasury yield curve rose substantially, as markets increasingly priced in lower Fed Funds rates for a longer period while also pricing in a higher long-term risk of inflation, which is effectively another form of sovereign default. The spread between 2-year and 10-year Treasuries rose from 236 basis points at the start of the quarter to a multi-decade high of 285 basis points near the end of December, before falling back to 270 basis points.

- The unwinding process began. The Fed stopped buying Treasuries in October after accumulating just under \$270 billion of such securities.<sup>8</sup> While it is impossible to ascribe the precise degree to which Treasury yields increased because of the cessation of purchases, it is clear that it could have been a contributing factor.

The Treasury Department stopped buying Agency MBS in December, after purchasing approximately \$220 billion of such debt since taking Fannie Mae and Freddie Mac into conservatorship in September 2008. The Treasury Department simultaneously removed the \$200 billion per-company limit on how much capital it could contribute to Fannie and Freddie.

Last, but by no means least, the largest banks that had received funds from the U.S. Government through the Capital Purchase Program (CPP) repaid over \$120 billion to the Government, not including \$4 billion of proceeds from the sale of warrants awarded to the Treasury Department alongside the capital injections. The banks exited the CPP with much higher common equity capital ratios, with Bank of America, Wells Fargo, and Citigroup raising over \$45 billion during a two-week period in December.

## THE QUARTER AND YEAR AHEAD OF US

There is no doubt that the actions taken since the collapse of Lehman Brothers have brought us to a much better place in terms of GDP than critics give credit for or even the most ardent optimists would have thought possible a year ago. We have recently begun to see broadening signs of economic stabilization. Indicators ranging from the U.S. Institute for Supply Management (ISM) survey to recent figures for temporary employment seem to augur, at minimum, stabilization, if not a return to economic and employment growth. That said, our key considerations regarding the United States going into 2010 are:

- The extension of the Fed's MBS purchase program is pivotal. The single most important decision we anticipate is whether the Fed will extend and expand the MBS purchase program beyond the previously extended March 31, 2010 expiration date and the original \$1.25 trillion size. We see it as pivotal that the Fed extends this program and purchases additional securities, as the housing market remains far too fragile to stand on its own. Importantly, if the Fed were to stop buying MBS as announced, we believe mortgage rates could rise by as much as 100 basis points, increasing the monthly payments for new borrowers by over 11% per dollar of debt. Such an increase would aggravate the decline in house prices that we expect even with sustained Fed purchases. Our expectation is that the Fed will announce its decision in its Federal Open Market Committee (FOMC) statement to be released on January 27.
- House prices continue to be weak. We expect house prices to decline through the first quarter and much of the year, as interest rate tailwinds have disappeared, even with Fed support for the market. We also see seasonality at work, as demand for homes tends to decline in the fall and winter months. Historically, supply would decline as well, as sellers would wait for seasonal strength to put their homes on the market. The problem now is that the houses hitting the market are, in many cases, distressed sales of foreclosed homes.
- Fiscal stimulus increases in importance. As we noted in our last quarterly outlook, fiscal stimulus becomes even more prominent in 2010 per the original legislated plan. As of 25 December 2009, \$253 billion of the \$787 billion of fiscal stimulus had been delivered to the economy through either tax cuts or spending programs. This amount is higher than the originally planned \$185 billion for 2009; clearly, it accelerated substantially in the fourth quarter. The planned spending increases and tax reductions for 2010 were originally set at just under \$400 billion, implying a 100 basis point incremental boost to GDP versus the stimulus in 2009. Potentially offsetting more than half of this stimulus will be the impact of reductions in state and local government spending.
- The removal of uncertainty about health care reform may be a positive factor. While perhaps no one is completely happy with the current proposals for health care reform, we are likely to see some closure on this issue in the first quarter. The removal of uncertainty in itself may well be a positive to watch, especially as investors see the final legislation and assess its implications for a wide range of companies in and beyond the health care sector. That said, it is clear to us that the current plans being discussed in Washington on all sides fail to bend the cost curve in any meaningful way. At best, the legislation will not increase deficits in the future. As such, even when this legislation is finalized, which we view as very probable, we are likely to be revisiting the topic for years to come.

- M&A activity will pick up. We believe M&A activity levels will increase throughout the year ahead. The longer interest rates remain at current, historically low levels on an absolute basis, the more M&A activity we expect to see. Even with the equity market rally in 2009, accretive acquisitions can be accomplished in a wide range of industries. We believe that one side effect of the differentiation in performance, which we expect between companies with strong balance sheets, robust organic cash flows, and operational flexibility and their peers, will be an increase in the number of strategic sellers. These sellers would be CEOs who, recognizing that their ability to deliver the cash flow shareholders expect is impaired, will try to maximize value by selling. As buyers, the strong companies will likely be better positioned than they were in the past, with cash on hand and the ability to borrow money at low, tax-deductible interest rates.

Through 2010 and beyond, the secular trends we see as most important are:

- Deleveraging will continue. As discussed above, we believe we are at the beginning of a multi-year period during which debt levels relative to GDP will decline. We have only just begun this process and will watch both the absolute ratio of total debt to GDP as well as the composition. Clearly, the socialization of debt and risk entails certain perils — foremost among them, the fact that the risk-free curve increasingly represents the aggregated risk of the private-sector constituents. Put another way, the term “risk-free rate” will become decreasingly relevant, as U.S. sovereign debt becomes riskier from a credit perspective and from the perspective of heightened risk of inflation—as politicians may be tempted to devalue the debt.
- Savings rate will rise. The flipside of the deleveraging story is that of savings. Even though equity returns for investors have been negative for the last decade, and short-term interest rates are effectively at zero, Americans continue to save well below historical levels relative to their disposable personal income. Even with the recent increase to about 5%, savings rates remain well below the 7% to 13% we have observed historically.<sup>9</sup> While Americans have been a characteristically optimistic people in the past, retirement requires more than enthusiasm. It requires cash. Given the growing fiscal debt and contingent liabilities facing the U.S. Government, we believe consumers will be forced to save at substantially higher levels. This will not happen overnight, but will instead be a multi-year/decade phenomenon as well.
- The composition of U.S. economic activity will recalibrate. One of the biggest opportunities, from a secular perspective, will be in assessing the shifts that will occur in the U.S. economy, and the timing thereof. Put simply, the representation of the financial industry has already declined and is unlikely to reach prior peaks again for decades. We believe certain aspects of the consumer discretionary sector will change substantially, as will the energy and technology sectors. We are sustaining our history of innovative research as it relates to these and other topics to ensure our scenario analysis around each company and sector fully incorporates opportunities, as well as risks.
- Inflation/deflation risk will heighten. In the past, we have made clear our base case view that inflation is unlikely to be a major problem for several years. We also see substantial deflationary pressure in the intermediate term from deleveraging and the associated decreases in consumption to fund higher savings rates. Beyond these economic factors, at some point the U.S. Government will have to wind down its stimulus programs, creating another deflationary force through some combination of decreased government spending and increased taxation, both of which equate to less consumption of goods and services. Beyond these topics, however, we are keenly aware of the risk of longer-term inflation and, importantly, of market perceptions regarding such risk. This past quarter, we had a small taste of what can happen to the sovereign yield curve. This is only a taste so far, but one that could become quite bitter.
- Sociopolitical pressure will increase. A confluence of events is likely to lead to increasing sociopolitical pressure in the United States. Approximately 29% of Americans over the age of 25 have earned a college degree or reached a higher level of education.<sup>10</sup> These individuals experienced an unemployment rate of 4.9% as of November 2009, versus less than 2% only three years earlier.<sup>11</sup> The other 71% of the country, however, is enduring a much more elevated level—in the range from 9% to 17.2%—and duration of joblessness. We do not expect this divergence to end anytime soon, particularly considering that the recalibration of capital flows and economic activity in the United States will put significant pressure on industries requiring less-skilled labor to reduce costs relative to overseas competitors. This topic has no obvious punch line, but could have ramifications for taxes, inflation, and a wide range of policy debates.

## CONCLUSION

While conditions for investors have continued to improve through the most recent quarter and for 2009 overall, we believe we will see new forms of opportunity and uncertainty in the quarters and years ahead. This environment demands that managers rely on forward-looking, fundamental research to make investment decisions. As the economy deleverages and recalibrates, we believe our investment focus on balance sheet strength, robust organic cash flows, and the resulting operational flexibility will continue to deliver strong results.

*Written by:  
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## NOTES:

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1 Source: U.S. Federal Reserve, U.S. Federal Housing Finance Agency, U.S. Treasury Department 2 Source: Bloomberg

3 Source: Bureau of Economic Analysis

4 Source: U.S. Federal Reserve, Bloomberg, U.S. Treasury Department, Social Security Administration

5 Refer to Lazard's Investment Focus paper "A Different Kind of Leverage," 5 January 2010, available at [http://www.lazardnet.com/lam/us/literature\\_research.shtml](http://www.lazardnet.com/lam/us/literature_research.shtml)

6 Source: Commercial Mortgage Alert

7 Source: Bloomberg

8 Source: U.S. Federal Reserve

9 Source: Bureau of Economic Analysis

10 Source: U.S. Census Bureau

11 Source: Bureau of Labor Statistics

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