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Differentiation Has Just Begun

In the third quarter, we moved further into economic normalization. In spite of many investors' evident willingness to apply disproportionate weight to the most recent economic and market observations, we continue to believe that we are at the beginning of a multi-year period of differentiation. Going forward, we believe that we will see significant dispersion of returns among winners, survivors, and losers, as the United States transitions from the era of disinflation to an economy driven by something other than excessive consumption and cheap, readily available leverage. Over the past investment cycle, the markets significantly underemphasized balance sheet quality and cash flow strength because of the vast availability of leverage.

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. 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.

THE QUARTER BEHIND US

As we forecasted in our third-quarter outlook, house prices did increase, and a number of other factors aligned to drive a substantial rally in credit and equities. As we outlined in a conference call in mid-August,¹ we see the potential for these gains to be sustained and even extended in the near term, as house prices increase further, credit spreads continue to compress under the weight of direct U.S. Federal Reserve (the Fed) intervention, inventory depletion dissipates, and fiscal stimulus spending features more prominently than it has to date.

The third quarter can be characterized generally as one in which the good news outweighed the bad:

- House prices rose. As reported in the last week of the quarter, the S&P/Case-Shiller 20-City Composite Index rose by 3.6% from the end of May to the end of July. The increase in prices was driven primarily by the decrease in mortgage rates over the period from October 2008 through May 2009, which drove demand for houses. The decrease in supply resulting from the various foreclosure mitigation efforts is likely to benefit results in 2010.
- Credit markets continued to recover. The cost of credit continued to decrease through the quarter, with the Moody's Baa Corporate Credit Index yield falling to 6.17%, only 53 basis points above the all-time low observed at the peak of the credit bubble and roughly in line with levels last seen in the 1960s.² The decline in the cost of funds was driven by lower levels of debt issuance and by increased demand from investors. In the third quarter, over \$110 billion flowed into long-term fixed-income funds, according to the Investment Company Institute (ICI), up significantly from \$89 billion in the second quarter, and \$53 billion in the first quarter. During the same time period, money market outflows were \$236 billion. Roughly \$70 billion of the balance flowed into deposit accounts, according to the Fed, as institutional and retail investors saw incremental yield pick up from basically anywhere other than money market funds.
- Earnings were better than expected. Even though the upside surprise to earnings was driven largely by expense cuts, revenue was roughly in line with consensus expectations for the second quarter. We saw numerous anecdotal indications that companies have completed the destocking of inventories and reached the point where they actually need to add employees to meet current demand. The results we see this quarter and next will be key to determining if those anecdotes actualize into a trend.

THE QUARTER AHEAD OF US

Our key considerations for the fourth quarter are:

- Credit markets will be on a knife's edge waiting to see how the Fed winds down its purchases of Mortgage Backed Securities (MBS). At the 23 September Federal Open Market Committee (FOMC) meeting, the Fed indicated it would reduce its purchases of MBS gradually, with purchases continuing through the first quarter of 2010. At the prior FOMC meeting, the Fed had announced it would stop purchasing U.S. Treasuries at the end of October 2009. As of 30 September 2009, the Fed had purchased \$260 billion of Treasuries. While this amount is much smaller, relative to total issuance, than the amount of MBS purchased by the Fed, we believe the Fed will be watching the market dynamics to see if the cessation of purchases materially impacts interest rates.

Over the next six months, the single biggest risk factor on our radar will be how the Fed handles this exit. We have discussed before the degree to which the Fed's purchases have driven credit investors out of the risk and maturity curves, pushed borrowing rates down, and allowed companies to refinance their debt. In the twelve months ended 30 September 2009, the Fed and Treasury have purchased or financed \$2.235 trillion of asset purchases. Even excluding the TARP-related investments, direct intervention in credit markets totals just under \$1.6 trillion—a massive amount of funding that has benefited the markets.

- House prices have perhaps one to two months of upside left. The next Case-Shiller home price data, which will be released at the end of October, will reflect virtually all of the benefits of the decreases in mortgage rates over the last year. The November release will reflect mortgage rates that were in force as recently as July, when they were up 50 basis points from their lows, implying a monthly payment approximately 5% higher per dollar of borrowing.

We believe that the end of the tailwinds derived from lower rates will combine with a seasonality factor. Typically, home sellers attempt to time their sale to match demand. Demand tends to be highest in the spring and summer months, when it is easier for families to move without disrupting school schedules and to avoid unfavorable weather. Unfortunately, banks that foreclose on homes do not have the luxury of timing borrower defaults. As a result, they generally try to sell homes year-round. Sales in the winter months, however, are unlikely to be met with adequate demand to sustain prices, especially as tax credits expire and interest rate reductions start to reverse.

- Fiscal stimulus will increasingly benefit the economy. The funds committed as part of the American Recovery and Reinvestment Act of 2009 (ARRA) are now starting to have an impact, which we believe will last through 2011. As a reminder, the stimulus package totaled \$787 billion, of which \$288 billion was in the form of tax relief, \$275 billion was for contracts, grants, and loans, and \$224 billion was for entitlements such as Medicaid and student loans. Of the \$288 billion of tax relief, only \$62.5 billion had benefited taxpayers as of the end of August.³ (This makes sense, as the tax cuts are applied over a number of years, with a foregone revenue “cost” for each year.)

Of the \$499 billion targeted for spending, \$308 billion worth of target projects has been announced, \$250 billion is available for funding, and \$107 billion has been paid out.³ Therefore, the amount of cash likely to flow in the coming quarters is sizable, with every \$140 billion portion equating to about 1% of GDP. Going forward, we believe this will have a meaningful impact on employment trends and, consequently, on corporate revenue.

CONCLUSION

While conditions for investing are substantially better compared to what they were a year ago, uncertainty continues to cloud the outlook for the quarters ahead. This environment demands that managers rely on forward-looking, fundamental research to make investment decisions. As we move toward a new economic backdrop and the era of disinflation fades into history, we believe that our investment focus on robust cash flow, strong balance sheets, and the resulting operational flexibility will continue to deliver strong results.

*Written by:
Ronald Temple, Managing Director, Portfolio Manager/Analyst*

NOTES:

1 Lazard Insights Conference Call Series, "Buy or Beware? Investing at the Crossroads," 17 August 2009, available at <http://www.lazardnet.com/lam/global/calls.html>

2 As of 9 September 2009. Source: Bloomberg and Moody's

3 Source: www.recovery.gov

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