

## MARKET COMMENTARY: THIRD QUARTER 2009

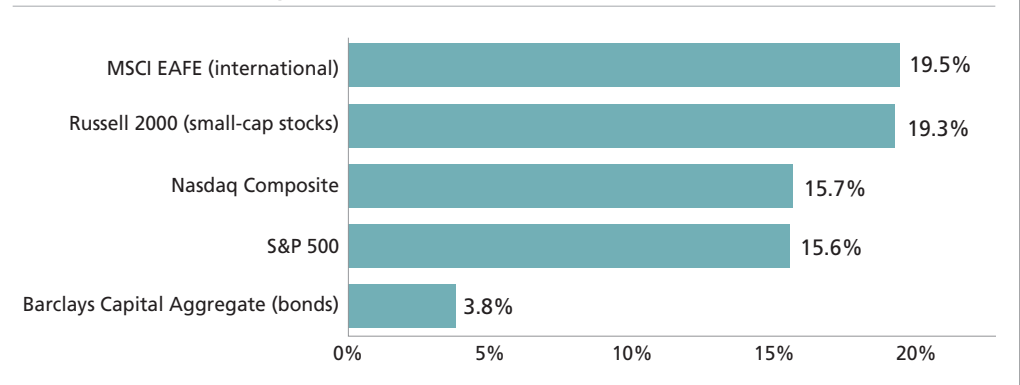
- Investors displayed growing confidence
- Economic indicators showed broad improvement
- Serious challenges remain, particularly for the consumer
- Stock selection may be critical in the current environment

If the early phase of the recent stock market rally reflected relief that the economic worst-case scenarios had not unfolded, the next phase, seen in the third quarter, appeared to show new confidence about a return to economic growth. Improving data, narrower credit spreads and moderate volatility all bolstered market sentiment as investors dipped into sidelined cash to participate in ongoing gains. Still, although we believe that equities have some “room to run,” the underlying strength and durability of the economic recovery remain in question. As such, we believe that careful attention to economic indicators and a focus on company fundamentals will remain essential in the months ahead.

After an initial two-month surge, beginning in March, equity markets moved into a tight trading range for three months as investors assessed economic news for signs of, not just stabilization but actual recovery. Gradually, the positives began to outweigh the negatives, and equities emerged with a strong, sustained rally that ran from early July through quarter-end. All told, the S&P 500 rose 15% for the quarter (for a total return of 15.6% with dividends), rising 17% from the start of the year and more than 50% from its March low. For the quarter, gains were widespread as all major sectors of the S&P 500 advanced. Financial stocks, led by consumer finance, real estate and insurance companies, posted solid returns. The information technology (IT) and industrial sectors were also strong, while telecomm services, utilities and materials stocks lagged. Foreign stocks shared in the rally, with the MSCI Emerging Markets (EM) Index posting especially strong results. Both the EM Index and the MSCI EAFE Index (representing developed markets) outpaced the S&P 500 for the quarter.

**FIGURE 1: STOCKS DELIVERED SIZABLE GAINS**

Market Returns: Third Quarter 2009



Sources: MSCI, Russell Investment Services, Nasdaq, Standard & Poors, Barclays Capital.

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### IMPROVING FUNDAMENTALS

In the past, there have been periods of market strength that appeared unjustified by economic fundamentals, and those rallies ultimately failed. However, we believe that support for recent gains and continued upward movement in equities comes from numerous sources, including:

- **Manufacturing trends**—The U.S. manufacturing sector, as measured by the Institute for Supply Management's (ISM) manufacturing composite, is now expanding for the first time in 19 months (after eight months of lessening weakness). According to ISM, new orders now far exceed inventories, which bodes well for an increase in production for the rest of the year and into 2010.
- **Improving real estate market**—the real estate sector is showing moderate improvement, as reflected in three straight monthly increases in home prices in May, June and July—something that has not occurred since 2006. Overall sales volumes have also been on the rise—for five consecutive months through August.<sup>1</sup>
- **Stabilizing labor market**—Although the unemployment rate remains very high, job losses continue to slow, averaging 256,000 per month in the third quarter compared to 428,000 in the second and 691,000 in the first.<sup>2</sup>
- **Positive leading indicators**—These elements and others have combined to support the case for economic strength overall. The leading economic indicators developed by the Economic Cycles Research Institute (ECRI) currently show pervasive, rapid growth, with the institute's long-leading indicator index hitting a 26-year high.
- **Favorable supply/demand for equities**—The second quarter saw the second highest volume of equity issuance in 19 years—roughly \$92 billion, much of it from financial companies seeking to improve their balance sheets.<sup>3</sup> Despite the large number, however, issuance was well absorbed into the market as investors increased their equity exposure. Given our expectation for relatively low issuance moving forward, we believe that supply/demand for stocks is positioned to remain healthy.
- **Normal credit markets**—The absence of credit was a huge pressure on many companies in the wake of the financial crisis. Today, the credit markets are far more accommodating. Prices for high-yield securities recently approached 90% of par (face value), compared to 55% last December, and the difference in yield between investment-grade bonds and Treasuries has actually returned to levels last seen in September 2008.<sup>4</sup> Given the price gains for bonds, we are seeing relative value in the equity markets.

Overall, we agree with the consensus that the release of third-quarter economic figures will show positive growth—the first time that has happened since the second quarter of last year. Moreover, the latest quarterly earnings season indicates to us that earnings have possibly troughed, and that many companies are well positioned to benefit as the economic environment improves. During the economic downturn, companies were aggressive in cutting expenditures and reducing inventories. As a result, we believe there is considerable operating leverage (with additional revenues providing more earnings per dollar) and, thus, potential for higher profit margins moving forward.

<sup>1</sup> Home prices are represented by the Case-Shiller Home Price Index. New and existing home sales data are provided by the U.S. Census Bureau and National Association of Realtors, respectively. All figures are month-over-month.

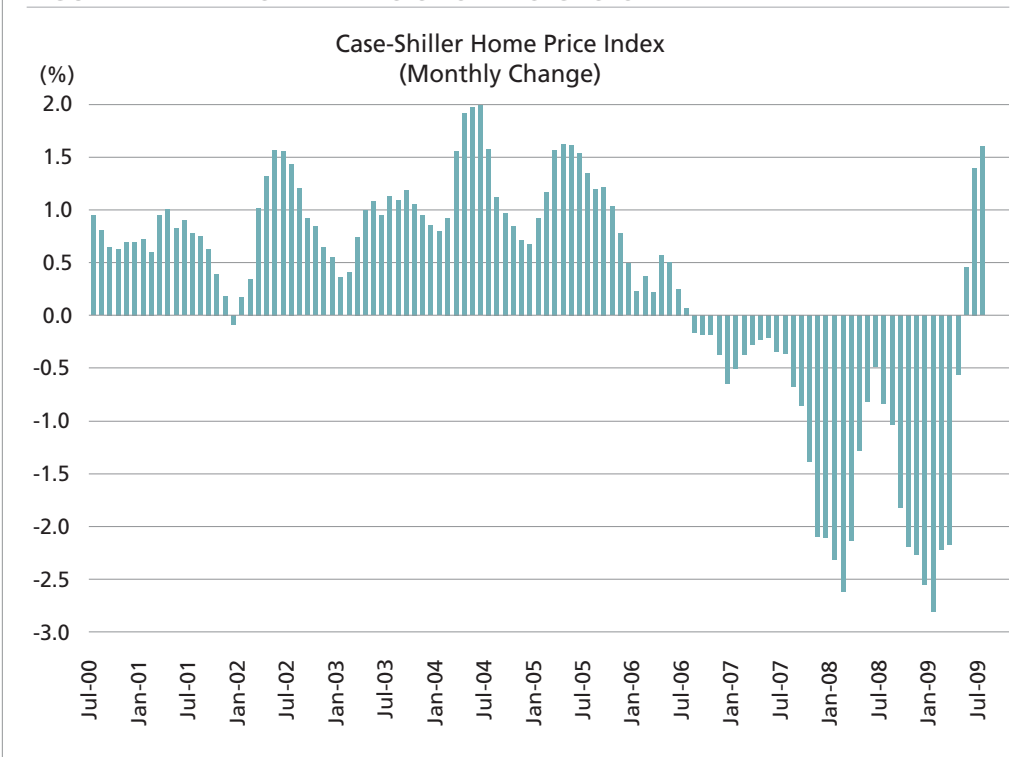
<sup>2</sup> Source: U.S. Department of Labor.

<sup>3</sup> Source: Merrill Lynch.

<sup>4</sup> Source: Barclays Capital. High yield represented by Barclays Capital U.S. Corporate High Yield Index average price.

Given the pressures faced by domestic consumers, we believe that the current recovery is most likely to benefit cyclical business sectors.

**FIGURE 2: REAL ESTATE HAS SHOWN SIGNS OF LIFE**



Source: Standard and Poor’s. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal.

Past performance is no guarantee of future results.

Despite all these positive trends, we are not anticipating an economic boom by any means. As we’ve said in the past, the withdrawal of cheap credit and losses in the real estate and financial markets have severely hindered the spending power of consumers. Although the labor market is stabilizing, we believe that unemployment will probably remain high as job growth lags in the current economic recovery.

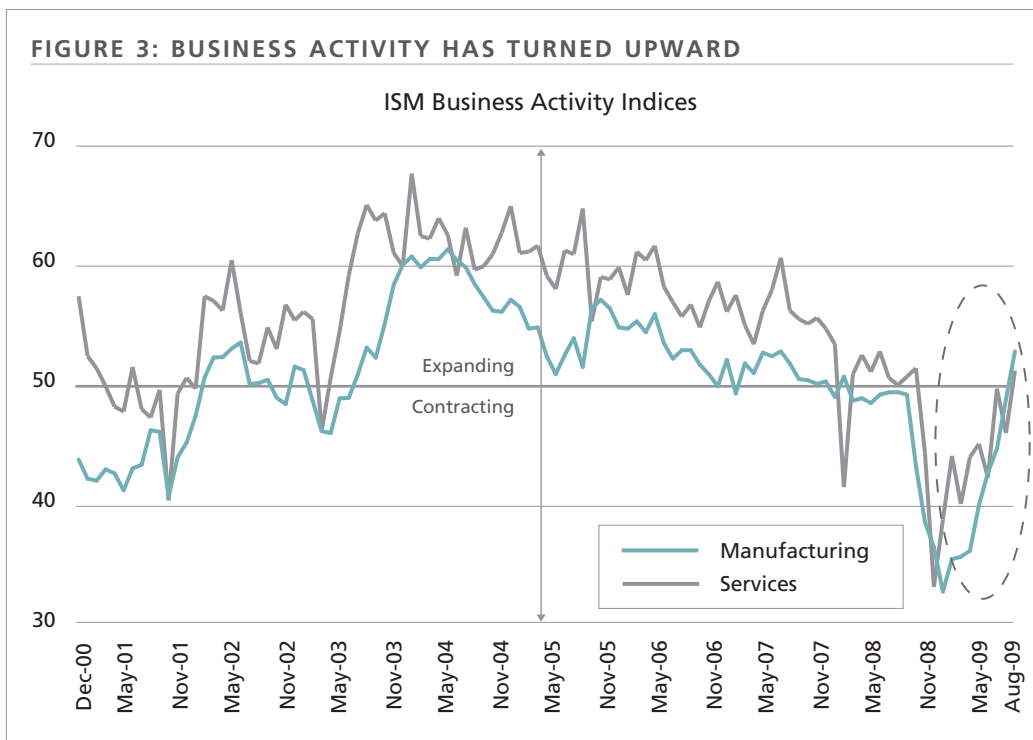
As such, we anticipate that consumers will go through an extended period of “deleveraging” as they mend household balance sheets. Recent statistics are not encouraging. For example, consumer credit outstanding plunged by a record \$21.6 billion in July—the sixth consecutive decline—following a \$15.5 billion drop in June.<sup>5</sup> Of course, increased savings has a positive side but, from a growth standpoint, represents a long-term negative offset to the economic benefits of government stimulus.

**INVESTING FOR RECOVERY**

Given the pressures faced by domestic consumers, we believe that the current recovery is most likely to benefit cyclical business sectors such as energy, technology, industrials and materials. We anticipate that companies with exposure to foreign markets, recovering commodity prices and stimulus infrastructure spending should be particularly well positioned. In our opinion, consumer discretionary businesses will have a difficult time, suggesting that consumer staples (which sell goods needed even during times of weakness) are a more secure alternative. Still, it bears noting that emerging market populations are far less debt-laden than their established market counterparts, potentially benefiting global firms with greater exposure to emerging market consumers.

<sup>5</sup> Source: Federal Reserve

Overall, we believe that this is a good time to be an equity investor.



Source: Institute for Supply Management. Manufacturing is represented by the ISM's Purchasing Managers Index. Services are represented by the ISM Non-Manufacturing Business Activity Index. Figures above 50 represent expansion.

In terms of asset allocation, recent share price gains have come from across the equity markets, but the most pronounced strength domestically, as of late, has been in value and small-cap stocks. On the fixed income side, high-yield bonds have been standouts. These are areas that traditionally outperformed early in economic recovery, and we believe that they will continue to show leadership over the near future. Although individual portfolios may vary depending on the investment needs of the client, we think it makes sense to maintain exposure to these areas within a diversified portfolio.

Clearly, most signs currently point to a recovery, but it is still possible that things could go wrong. Economic activity has been heavily dependent on government stimulus and it remains to be seen how sturdy the private sector will be as the training wheels come off. Recent levels of spending growth have been astronomical and, if maintained, could pressure politicians to enact tax increases—something that has generally dampened economic activity. At this point there also remains considerable uncertainty about potential health care reforms as well as environmental and financial regulation which, depending on the outcomes, could have far-reaching consequences for growth.

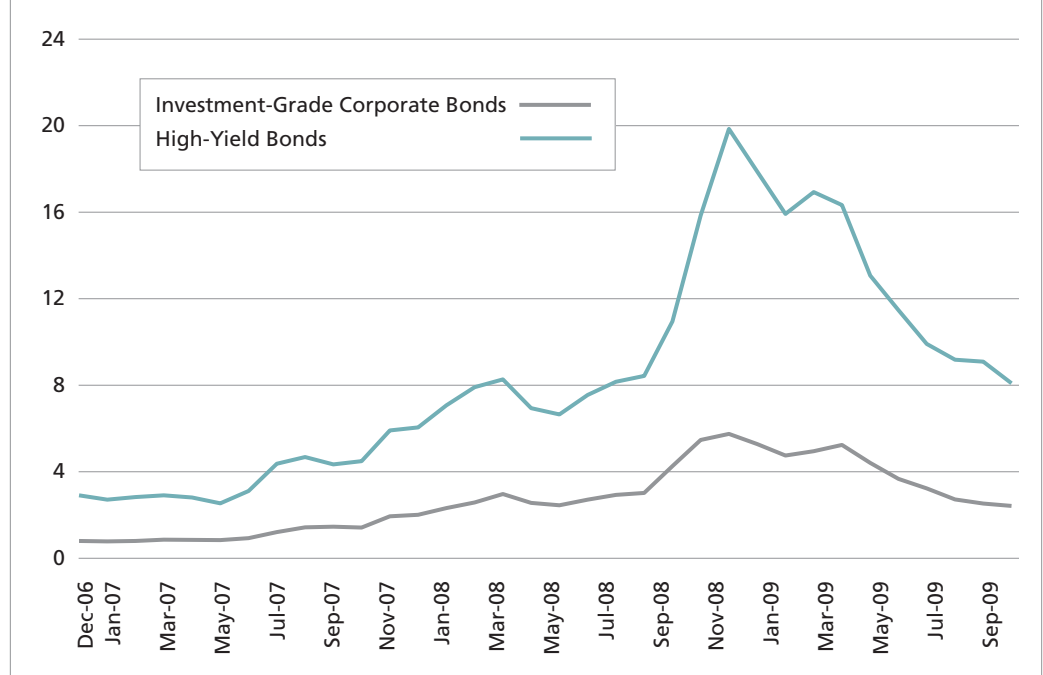
Overall, however, we believe that this is a good time to be an equity investor. Equity markets have experienced substantial gains since March as the real estate, labor and credit markets stabilized and investors recognized the beginning of an economic recovery. Although valuations have crept up, we believe that they are reasonable when taking into account likely earnings projections for next year. As for our portfolio managers, most are finding what they consider to be good investment opportunities in the current environment. Still, no one can predict the short-term swings of the market, so we believe that maintaining a long-term perspective, aligned closely with individual investment goals, continues to be highly important.

In both the Treasury and corporate bond segments, the market successfully absorbed a huge supply in new issuance.

**BONDS ENJOY ROBUST QUARTER**

During the third quarter, the bond market saw further reductions in credit spreads, or the difference in yields between Treasuries and other fixed income securities. The change reflected more willingness to take risk, as investors appeared to become increasingly confident in the potential for economic recovery, and continued moving cash back into the market. Although non-Treasuries generally did well during the period, corporate bonds—particularly the high-yield sector—were especially strong performers. In the investment-grade sector, industrial and financial companies saw relatively solid gains. Mortgage-backed securities also performed well but displayed some volatility after the Fed announced the curtailment of its buyback program.

**FIGURE 4: CREDIT SPREADS CONTINUED TO NARROW**  
Yield Over Treasuries (%)



Source: Barclays Capital.

Investment-grade corporate bonds represented by the Barclays Capital U.S. Credit Index. High yield bonds represented by the Barclays Capital U.S. Corporate High Yield Index.

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In both the Treasury and corporate bond segments, the market successfully absorbed a huge supply in new issuance. Additional Treasuries came to market as the federal government sought to monetize the expense of stimulus-related spending. As for corporate bonds, unlike earlier in the year when only blue chip credits generally had access to capital, issuers from middle and even low credit tiers were able to attract funding at reasonable levels. Also, in the wake of the credit crisis, many companies have become reluctant to use short-term financing, opting to let such securities expire in favor of issuing long-term debt—something that has also buoyed supply.

Portfolio managers with deep research capabilities and time-tested investment disciplines could have a significant advantage in navigating this healthier but still challenging environment.

The municipal market also saw favorable results, but with an unusual shift in supply/demand dynamics. In terms of supply, federal government-subsidized Build America Bonds accounted for almost a third of new issuance. These taxable munis—which have become enormously popular among institutional investors—have cut into the issuance of more traditional tax-exempt municipal securities. This, combined with renewed appetite for financial assets by individual investors and mutual funds, has helped lift municipal prices while reducing yields, particularly at the short-to-intermediate end of the maturity spectrum. Despite these gains, the financial condition of state and local governments remain challenged, due to reduced tax revenues and growing social services costs.

In considering the overall economic picture, one positive is what we consider the minimal current risk of renewed inflation, as wage and costs pressures remain benign. Still, our fixed income managers are watching the dollar carefully, as continued weakness could apply downward pressure on bond prices. Moreover, we believe, as most observers do, that the federal budget deficit could turn into a real problem if not addressed over time.

Looking forward, it seems advisable to take a cautious approach in fixed income, given recent gains. Corporate bonds and other non-Treasury issues still have a yield advantage over government securities, but narrower spreads mean that investors should be more selective in terms of the issues they consider purchasing. As for business sectors, we believe that financial and industrial bonds offer a relatively favorable risk/reward relationship. Within municipal portfolios, general revenue bonds and other conservative issues seem appropriate given the economic difficulties still facing the country.

#### FINAL THOUGHTS

The psychology of the marketplace has changed drastically from earlier in the year. In our view, the massive government intervention in the economy has helped steer a course to recovery, reflected in broad improvements among economic indicators. At the same time, the equity market has come a long way in a short time, suggesting that near-term setbacks may be possible—even if you believe that the market has fundamentals on its side. Moreover, the surge in valuations means that stock selection may be highly important in protecting assets and seeking appreciation potential. Portfolio managers with deep research capabilities and time-tested investment disciplines could have a significant advantage in navigating this healthier but still challenging environment.

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Diversification does not guarantee a profit or protect against loss.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance.

The Nasdaq Composite Index is a broad-based capitalization-weighted index of all Nasdaq National Market and Small Cap stocks. The index was developed with a base level of 100 as of February 5, 1971.

The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. & Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom. The index is translated into U.S. dollars.

The Barclays Capital U.S. Aggregate Index represents securities that are U.S. domestic, taxable, and dollar-denominated. The index covers the U.S. investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The Barclays Capital U.S. Credit Index is made up of publicly issued, investment-grade U.S. corporate and foreign debentures and secured notes that meet maturity, liquidity and quality requirements. Corporate sectors include Industrial, Utility and Finance, which include both U.S. and non-U.S. corporations. Non-corporate sectors are Sovereign, Supranational, Foreign Agency and Foreign Local Government.

The Barclays Capital U.S. Corporate High Yield Bond Index includes fixed rate, public nonconvertible, non-investment-grade issues registered with the SEC that are rated BA1 or lower by Moody's Investor Service.

The Barclays Capital U.S. Treasury Index is an unmanaged index consisting of U.S. Treasury issues.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2006, the MSCI Emerging Markets Index consisted of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

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