



# CIO Update

## Engines of Growth

**SUMMARY** The economy remains sluggish, but companies are finding ways to grow. We expect inflation to stay tame and corporate profits to continue improving. Valuations for certain equities and fixed-income securities are compelling.

Key themes to watch include rising dividend payouts, merger-and-acquisition activity and the impact of potential quantitative easing on the U.S. Treasury market.

### KEY POINTS

- We expect to see more big momentum swings in the equity market, creating attractive entry points for long-term investors.
- Dividends are rising as companies return increasing levels of excess cash to shareholders.
- We are seeing values in areas of the bond market, despite some yields near record lows.
- Security selection remains critical in a sluggish U.S. economy and uneven global recovery.



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## ENGINES OF GROWTH

Why did U.S. stocks post their best September since 1939? Skeptics in the double-dip camp might call it irrational exuberance. But we think that these double-dippers underestimated the resiliency of corporate America and the global economy. U.S. economic growth of around 2% over the next 15 months would not be terrific, but it doesn't point to a collapsing economy, in our opinion. U.S. corporate profits and finances are in remarkably good shape, we believe, bolstered by unprecedented cost cuts, deleveraging and balance-sheet repair.

Of course, we understand that economic challenges remain. While the U.S. recession officially ended in June 2009, it hasn't felt that way for millions of Americans. Nearly 15 million people remain out of work, and the economy isn't generating enough jobs to keep pace with population growth, let alone slash the unemployment rate. Many companies also see unquantifiable costs in the new health care law, changes in tax policy and financial regulations—more reasons they're on the hiring sidelines. The modest recoveries in retail sales and the housing market, meanwhile, leave economic growth below levels of headier times a few years ago.

Despite these headwinds, we see opportunities in individual securities, and we're confident that evaluating companies on their fundamentals is the way to prevail in this uncertain era. For investors with a long horizon, we recommend a balanced approach, holding a range of equities and fixed-income assets for the best potential risk-adjusted returns. Patience isn't easy, but it can be rewarding.

## EQUITIES HAVE ROOM TO RUN

Investors have been fickle this year, piling into the markets one month only to pull out a few weeks later. With the economy sending mixed signals, we wouldn't be surprised to see a few more big momentum swings. Yet we believe the downward moves have provided attractive entry points to pick up companies with good fundamentals and long-term prospects. Even after the recent rally, stock valuations are compelling. In our opinion, many large-cap U.S. stocks are trading at price-earnings multiples that are below average, especially when considered in the context of today's low interest rates. Free cash flows are rising, indicating that companies are finding ways to grow in this environment. And dividends are back in vogue. More than 175 companies in the S&P 500 Index have initiated or raised dividends this year while only three have lowered or eliminated distributions. Even some technology "growth" stocks have joined the payout party, returning excess cash to shareholders.

We believe that dividends are likely to provide a meaningful portion of the total expected returns from equities in the future and we like the financial discipline they impose upon corporate managers.

Foreign markets are providing significant new growth areas too. Rising household incomes in China, Eastern Europe and Latin America are boosting demand for imported goods. China may be putting the brakes on its economy, but its gross domestic product still soared 9.6% in the third quarter, with retail sales up 18.8% in September alone. In Europe, Germany continues to surprise on the upside, with the manufacturing and services purchasing indexes rising in October ahead of consensus forecasts.

Granted, high unemployment and a weak housing market are hindering a broad recovery. But stocks may not need a raging economy to move higher at this stage. Non-financial U.S. firms are sitting on more than \$1.8 trillion in cash—money that may accelerate dividends, share buybacks, acquisitions or business investment, fueling higher stock prices. Consumer spending appears resilient for "affordable luxury" goods like iPads from Apple. And we're seeing a return of "animal spirits" to the markets as merger-and-acquisition activity picks up. We can't say when, but we believe the markets will eventually start to appreciate the value of fundamentally solid firms.

## FINDING VALUES IN BONDS

Investors learned to love bonds this year; money flows into fixed-income funds have surged by over \$220 billion through September. The flows have prompted media buzz of a "bond bubble," particularly at the short end of the Treasury curve, where yields have been flattening and are near record lows. Certain areas of the market have lost some luster in our view. However, we disagree with the notion of an across-the-board bond bubble. Low inflation data is supportive of current yields. And we continue to see value in investment grade and high-yield corporate credits, along with some foreign corporate bonds. Highly leveraged companies, in particular, could be in a good position to benefit from improving cash flows should the economy strengthen. The capital markets have become more receptive to these companies, allowing them to refinance. That has helped keep default rates low. High-yield bonds generally benefit from investor demand for income in a low-rate climate.

Naturally, we're always on the lookout for changes in expectations for inflation. Recent data points have been disinflationary, and we expect inflation to trend between 1.0-1.5% over the next 12 months. But we remain concerned that

inflation could ramp up quickly as the economy returns to a more normal footing, eventually leading to rate hikes and price pressure across the yield curve.

Another issue we're watching is potential QE2—a second attempt by the Federal Reserve (Fed) to stimulate the economy with quantitative easing. The Fed's first effort involved buying more than \$1.7 trillion of U.S. Treasuries and mortgage-backed securities in an attempt to lower long-term rates and pump more money into the economy. QE2, expected to be announced in early November, isn't likely to be as large, and it's too soon to say if it will work as intended. But gold prices have soared, in part, on expectations that it may do the trick, fueling inflation and driving down the dollar. We're not yet in that camp, but it's a risk we're monitoring closely on your behalf.

### **LOOKING AHEAD**

For investors, one issue now is whether to buy the market through a passively managed index strategy or go with an active approach. Buying an index fund may certainly look appealing from a risk perspective. But the major indexes may prove to be a poor tool for risk management and preservation of capital, saddling investors with large stakes in companies that may have deteriorating fundamentals. This approach may be risky in such an uncertain and volatile climate, and some of the best opportunities may not be the companies that dominate an index. More than ever, we believe, it's critical to dig deep and evaluate companies on their fundamentals: cash flows, balance sheets, capital structures and credit strategies. In our view, it's the only way to determine potential returns and companies that will ultimately reward shareholders.

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See last page for important disclosures.

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