



# CIO Update

## Opportunities in the Recovery

**SUMMARY** Prospects for the recovery continue to be stronger than consensus estimates, boosting our outlook for the economy and risk assets. We think U.S. equities remain undervalued and will outperform in 2011. Despite the rise in yields, bonds remain attractive when evaluated on real returns. Key themes to watch include a recovery in housing, sovereign funding issues in Europe and inflation expectations in the U.S. and emerging markets.

### KEY POINTS

- High-quality growth companies are trading at narrow premiums to value companies, lending support for growth stock valuations.
- Sectors such as consumer discretionary, industrials and technology could outperform as economic indicators continue to improve.
- Higher yields and steeper curves make fixed income more attractive in a low inflationary environment.
- In a volatile investing climate, individual security selection will hold the key to higher risk-adjusted returns in equities and fixed income.



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## OPPORTUNITIES IN THE RECOVERY

As we head into 2011, the big surprise for the year could be that the recovery looks more and more normal by the day. Economic data points continue to impress, defying the skeptics who predicted a slide back to recession. Recent clarity on taxes provided corporations with more transparency and should facilitate greater investment and spending by companies. While unemployment remains high, job creation will follow if companies continue to show strong profitability and see growth on the horizon, which we expect to happen. Overall, the recovery appears to be gaining momentum, challenging the thesis of a “new normal” economy.

One reason we’re more bullish is the return of the American consumer. Holiday sales were up 3.8% in 2010—the best performance since 2006. This isn’t just good for retailers; it bodes well for other sectors since holiday sales are typically a strong leading indicator of growth in the following year. U.S. auto sales are recovering too, rising 11% in December. That’s a sign of healthier confidence and more robust spending on durable goods.

Fiscal and monetary policies are working together to fuel economic growth. The extension of the Bush tax package for two years will add an estimated one percentage point to economic growth in 2011. Economists may debate the fiscal responsibility of the package and its long-term impact on the deficit, but with the improved transparency on taxes, the near-term effect is likely to be an increase in spending and confidence. At the same time, the Federal Reserve (Fed) has signaled that it intends to continue to keep liquidity high in the system with a primary goal of reflating the economy and risk assets through additional quantitative easing (QE2), as well as reinvesting coupon and principal payments in the Fed’s current portfolio. All told, we believe these steps will help the healing process now underway.

Naturally, our optimism comes with caveats. Recent data on home prices have been disappointing. The S&P/Case-Shiller Home Price Index of 20 major cities declined 0.8% in October from a year earlier, and six major markets hit their lowest levels since prices started to decline in 2006. The data points have some economists warning of a housing double-dip in 2011. We continue to view a potential downturn in housing as the biggest risk for the domestic economy.

As we have said in the past, imbalances in the U.S. and global economy will continue to take years to work through and we think it’s likely that new shockwaves could rattle the markets. Two examples might be further concerns about sovereign funding for troubled European nations as well as state and local government budgetary challenges in the U.S. QE2 helps address the government’s deficit funding needs near-term, but it raises concerns about the Fed’s balance sheet and exit strategy. Eventually, self-sustaining growth will

be necessary to facilitate robust job creation. Nearly 10 million Americans remain out of work, and even if the economy recovers 4 million jobs this year, the natural level of unemployment would still be relatively high.

Foreign markets present a mixed picture. Europe seems increasingly split between healthy northern countries and weak southern ones (plus Ireland). Expanding European economies like Germany and France must contend with deflationary pressures and new funding requirements in peripheral regions. Spain and Portugal have funding needs that will have to be addressed in the first half of the year. The upshot is likely to be more volatility in 2011. On the plus side, the weaker euro is fueling export growth for Germany and other countries, leading to better than expected growth and increasing inflation pressures. And we expect to see greater harmonization of fiscal policy between euro zone countries—a development that may cause near-term instability but should build confidence in the long run.

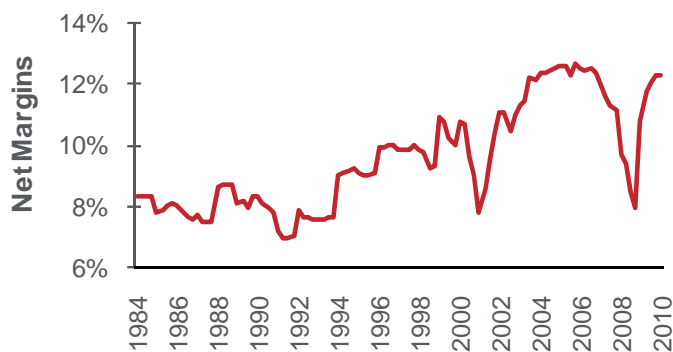
In general, we remain sanguine on emerging markets. Growth prospects are superior to those of developed markets, and the risk profile has improved as emerging economies move to more internal, consumption-based models, relying less on exports for growth. This creates opportunities, along with some new pressures. Developing markets in Asia and Latin America are grappling with inflationary pressures and huge capital inflows. China has raised short-term interest rates several times to curb rising pricing and may continue to restrict lending to deflate a developing property bubble. Elsewhere, countries such as Brazil have imposed capital controls and taxes on foreign investment, measures likely to continue into 2011.

## EQUITIES REMAIN ATTRACTIVE

We think U.S. equities will outperform in 2011. QE2 sparked a rally in the fourth quarter, and additional stimulus going into the system should provide further support. President Obama has tilted toward the political center and fiscal discipline may finally be addressed with new Republican strength in Congress. Ideally, we’ll see a “Goldilocks” scenario: the U.S. economy will get a short term boost from the stimulus and increased credibility on the international stage if Washington tackles the deficit. The dollar’s recent strength indicates that investors are growing more confident in this scenario playing out.

Despite the fourth quarter rally, equity valuations remain moderate by historical standards. Companies have emerged from the recession with pristine balance sheets and net margins of 12.3%, close to the highest level in more than 25 years for large firms (see chart on following page). If margins revert to the mean, higher-margin companies will face less profit pressure than lower margin firms. And if the economy weakens, firms with high margins will have more of a profitability cushion. We think that gives high-quality, growth

## Net Margins for Russell 1000® Index Companies



Source: FactSet. As of 12/31/2010.  
Net margins = net profit/revenue.

companies several ways to win. Other positive indicators for stocks include an increase in mergers-and-acquisitions activity—evidence that companies are starting to deploy their cash. The next leg up would be hiring, which is likely to follow as confidence improves.

With the outlook improving, we think that economically sensitive sectors could outperform. Consumer discretionary, energy, technology and industrials may do well if economic indicators continue to gain strength. Increasing clarity on regulations may help health care and financial services. As rules become more clearly defined, these sectors could regain some market leadership.

Finally, we believe that money is likely to flow back into stocks after a multi-year period of outflows. In the U.S., cumulative equity outflows from 2008-2010 (through November) were \$273 billion. With the market up significantly off the lows of early 2009, we believe investors will start to feel more confident in reallocating some of their portfolios to equities. In fact, the mutual fund industry experienced positive flows into equity funds in November. We expect this trend to continue and to be supportive to equity valuations in 2011 and beyond.

Active managers have faced a challenging environment as macro forces dominated the market and equity correlations soared to record levels in 2010. Correlations have come down in recent months, however, and are likely to decline further if the economy continues to show strength. Going forward, fundamentals should matter more as the market increasingly differentiates companies based on their balance sheets, growth rates and competitive advantages. We believe this will create a better environment for active managers to add value through stock selection.

### HIGHER YIELDS & OPPORTUNITIES IN FIXED INCOME

Bonds had a difficult fourth quarter as yields rose sharply and some of the risk aversion bid into the Treasury market receded. The agenda in Washington is now clearly

reflationary, and fiscal and monetary policies will be a headwind for the bond market over the next few years. At the same time, we think the back-up in yields is justified as economic data have come in better than expected. Prospects for the recovery continue to be stronger than consensus estimates, and bonds remain attractive when evaluated on real returns (yield minus inflation).

At this point, we are less concerned about an inflation spike and higher interest rates than with a continuation of low, stable inflation. We think concerns around deflation are overblown as policy makers and the Fed have made fighting deflationary pressures a top priority. Interest rates will move with underlying economic fundamentals and market reactions to global imbalances. We will be paying very close attention to inputs into the inflation outlook as well as monitoring inflation expectations.

While the media discusses “bursting bubbles,” the more this gets overplayed the greater the opportunities for investors. Higher yields and steeper curves make fixed income more attractive in a low inflationary environment. In this context, we continue to favor corporate credit as we believe the health and profitability of corporations are improving. The new wave of financial conservatism in corporations is a welcome sign. We think it represents a new mindset for management that will result in more prudent uses of balance sheets and disciplined investment. More conservative capital structures should lead to tighter credit spreads.

In this volatile climate, similar to selection of individual equities, individual credit selection holds the key to higher risk-adjusted returns. We believe that the construct of the indices does not reflect a proper risk appetite for most investors, in our view, forcing investors to hold debt issues that are not fundamentally improving, thus presenting greater downside risk. We believe an active approach with a focus on fundamental company analysis will yield higher risk-adjusted return with better downside protection long-term.

### LOOKING AHEAD

Investors should be paying keen attention to the strength of the recovery in the United States, as well as the imbalances that exist in the global economy. Strong Asian and emerging market growth is fueling inflation in certain regions and forcing central banks to raise rates while developed nations are continuing to aggressively pursue loose monetary and fiscal policies. In this environment, investors need to focus more than ever on balance in their portfolios, taking into account current valuations and expected returns. The global recovery is well under way. This will present new opportunities in the markets as well as new challenges.

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Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index.

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