

MARKET PERSPECTIVES

NAVIGATING A STORMY INVESTMENT CLIMATE

After a relatively smooth start, 2010 has turned into a year of significant market turbulence. The trouble began in Europe, where worries about Greek solvency led to significant pressure on the country's debt. This contributed to concerns about the health of securities issued by Spain, Portugal and Italy and the exposure of banks to their sovereign debt.

Although initially considered a European problem, concerns spread quickly as global fixed income and equity markets weakened and the once-strong euro dropped to four-year lows.¹ Even with a massive bailout package by the European Union, including credit facilities and loan guarantees for member states as well as the purchase of government debt by the European Central Bank, investors remained on edge, most alarmingly on May 6, when the Dow Jones Industrial Average suffered a roughly 1000-point drop before regaining some ground later in the day.

What should investors make of the recent volatility? How serious are the problems it reflects? What should investors do? We asked several of our strategists and portfolio managers to provide their views on recent developments and offer their perspectives on where both hazards and opportunities may exist in the current environment.

MATTHEW RUBIN

Director of Investment Strategy

U.S. EQUITIES AND ASSET ALLOCATION

Does recent stock market volatility reflect underlying fundamentals?

In many ways, the problem of European debt and fears of contagion may have overshadowed what we believe are attractive U.S. fundamentals, both for the overall economy and specific companies. We believe the economic recovery will continue in the U.S. and more rapidly in the emerging markets and could potentially overcome the near-term volatility and noise that has presented itself.

What data support your view of the U.S.?

Primarily, we are encouraged by employment. Over the last four months, job growth has been better than analysts expected — much more so for the past two months. Some of this comes from census jobs, but you have to remember that, not long ago, we were losing 750,000 jobs per month.

But isn't unemployment still high?

The other side of the story is that the unemployment rate is sticky near 10%.² This is in part a function of the fact that more people are trying to reenter the job

¹ Source: Bloomberg.

² Source: Bureau of Labor Statistics.

Employment has proven much more favorable than many people expected.

market as the economy improves. But it also reflects the length of time people are out of work—in fact over 45% of the unemployed have been so for over six months.³ That's an extremely elevated level by historical standards. Overall, you'll probably see moderate job growth and high unemployment for a while.

But net-net, employment has proven much more favorable than many people expected, and should help drive consumption, which at about 70% of GDP has historically been very important to overall growth.

You've talked about the strength of corporate America. Do you still like what you see?

From a financial perspective, companies are very healthy now. Currently, there is about a trillion dollars' worth of cash sitting on corporate balance sheets. And you know that CEOs will become interested in deploying at least part of that as the economy stabilizes. I believe companies will begin utilizing that cash in the form of M&A activity and investment for future growth.

Also, earnings have been quite strong. Of the companies that have reported, about 80% have beaten earnings estimates for the first quarter.⁴ What's more encouraging is that top-line growth has also been solid, meaning that businesses are not just relying on cost-cutting to hit their numbers. We continue to see upward revisions in earnings estimates as well.

What about the impact of the problems in Europe?

Obviously, the debt levels in many countries—and not just in Europe—are a significant problem that won't go away quickly. They could prove to be a drag on global growth levels longer-term, but I do not think they are going to derail the economic recovery or instigate another bear market. Fundamentals are still positive and are not suggesting either of those scenarios right now.

We do believe that selectivity will be critical moving forward. The key question will not be whether you own equities but which equities you hold, and the ability of those companies to grow earnings and outperform. Unlike what we saw coming off the March 2009 bottom, we believe the market is shifting to where quality investments will be the performance leaders. We feel that you'll want to be much more selective, since beta won't be driving the market anymore.

Won't the reduction in government stimulus hurt the economy?

The monetary and fiscal stimulus that was deployed during the credit crisis was extraordinary. However, earlier this year, the Fed ended its quantitative easing strategies and it looks like the Obama fiscal stimulus will wind down by the end of 2010. Still, the Fed is maintaining its zero interest rate policy, and many people expect that to continue through this year and possibly into 2011. We agree that the Fed is likely to be very accommodative for some time, especially because inflation risk is fairly remote. This will be an important support for the markets and economic expansion.

We believe that selectivity will be critical moving forward.

³Source: Bureau of Labor Statistics.

⁴Strategas Research Partners.

Given the current fiscal picture, we believe that taxes are eventually going to go up.

Investors need to balance concerns about near-term volatility with total return potential over time.

Keep in mind that a key to continued growth has always been for the private economy to take over for the government as the key driver of the overall economy. Based on what we see, that is beginning to happen.

What other challenges do investors face?

Given the current fiscal picture, we believe that taxes are eventually going to go up and that the federal government and states are going to have to address expenditures. And even though the Fed is accommodative now, eventually rates are likely to go higher. That's part of what's creating uncertainty in the markets today.

We're also paying close attention to China and its government's policy decisions. There has been a great deal of concern about whether monetary policy will be too severe and undermine what has become a hugely important engine for economic growth. At the same time, China has been under pressure to revalue its currency; but with the problems in Europe, that pressure has eased to some degree, at least for now.

The weak euro may make life more difficult for American companies selling into Europe, but historically, most of our exports have not been to euro-denominated countries but to trading partners such as Canada, Mexico and various Asian countries. On the other hand, currency weakness should help many European companies to compete — something that should benefit investors with exposure to that region.

Where are opportunities currently? How are you approaching asset allocation?

Going back to selectivity, we believe that the choice of sectors and companies within sectors is most important. Within this overall framework, one segment we're looking at right now is late-stage cyclicals that could benefit as the expansion matures — which include parts of the Technology sector, as well as Industrials and Energy. At the same time, we believe that heightened market volatility is likely to continue for some time. As a result, we think that exposure to more stable areas such as Consumer Staples and Utilities appears to make sense. The dividends provided by the Utilities sector add to their appeal.

More broadly, investors need to balance concerns about near-term volatility with total return potential over time. Today, we still believe that maintaining exposure to stocks will be important in achieving long-term financial goals. At the same time, risk management will be crucial and can be achieved both through diversification and active portfolio management.

THANOS BARDAS

Portfolio Manager
Global Fixed Income Team

The big question is what the environment will look like over the next few years when we start to see more fiscal restraint.

FIXED INCOME

What factors are currently affecting fixed income markets?

As always, growth and inflation are the fundamental variables that are driving the fixed income markets. However, at times, other factors may intervene that affect market prices; and, this year, the issue of sovereign risk has been top-of-mind.

Why has sovereign debt become so important?

Stepping back for a moment, with the crisis that we saw from 2007 to early 2009, the private sector fell into a deep freeze, and governments had to step in to stimulate economic activity. As a result, fiscal deficits increased massively in many countries. The focus was on the U.S. for a while, but Europe had its own structural problems—particularly the dichotomy between a common monetary policy and individual fiscal policies that routinely failed to meet deficit requirements of the Maastricht Treaty. The crisis in Greece has had the effect of refocusing attention on deficits again.

Didn't the Greek bailout help?

The intervention by the European Union in early May was followed by a brief rebound in some markets, but we think this was primarily a function of short covering of riskier assets. Ultimately the bailout was viewed as too little too late, and there was continued weakness in both the euro and the debt of Greece and other so-called “peripheral” European nations.

Here in the U.S., we have since seen a move toward quality, with high yield spreads widening by about 80 basis points, and the spreads on investment-grade corporates and mortgages increasing by about 30 and 20 basis points each.⁵

What impact do you think these events will have on the economy?

It is too early to tell what the economic fallout will be. Fundamentals have been improving in the U.S. Corporate profits are solid and inflation is low. We believe that we're in a sweet spot right now. The big question is what the environment will look like over the next few years when we start to see more fiscal restraint. With the Greek crisis, the “bells are ringing” over the deficits and with moves to restrain spending, growth expectations in Europe are now lower. Now, price volatility reflects the attempts of investors to gauge what the economy will look like in the U.S. with spending reductions and the unwinding of some Bush tax cuts next year. One thing that isn't a current worry is monetary policy, since the current crisis has postponed any thought of rate hikes, especially given inflation conditions.

Where are you seeing opportunities?

For a long time, we were seeing value in non-Treasury sectors. Currently, we are more cautious not only because of the price movement that has been seen over the past couple years, but also because we would like to have more clarity on the response to the developments overseas. Still, we think that high yield securities remain relatively

⁵ Bond figures refer to the high yield, corporate and mortgage components of the Barclays Capital U.S. Aggregate Index.

BENJAMIN SEGAL

Portfolio Manager
Head of Global Equities Team

For the European Union,
this has been a major test.

attractive, given both expectations for lower defaults and their tendency to benefit as the economy moves out of recession. Commercial mortgage-backed securities also appear undervalued and should benefit from stabilizing business conditions. With commercial mortgage-backed securities, we think it makes sense to take a conservative approach, which includes focusing on the top of the capital structure.

INTERNATIONAL EQUITIES

What's behind the recent volatility in international equity markets?

One element is clearly the sovereign debt crisis in Europe. Another is China, as an increasing number of investors are concerned about the sustainability of growth and the risk that policymakers will step too hard on the brakes. Third, fiscal deficits in general are perceived as a worry, as are the austerity measures and tax increases that we believe will eventually follow. Also adding to uncertainty is financial regulation and how it will impact the industry.

Should the sovereign debt crisis have come as a surprise?

Everyone has known for some time that debt levels were an issue—and not just for “peripheral” countries. For example, the debt-to-GDP ratio in Japan is off the charts. However, the near default of Greek debt made the issue much more immediate and has led to worry that what happens there could happen elsewhere.

Do you think the bailout package was a success?

The final package came much later than it should have and, as a result, needed to be bigger than it might have been at an earlier point. It does address the issue of intermediate liquidity and requires Greece to implement major structural reforms. Still, it does not change fundamental issues such as high deficits, uncompetitive cost structures and low productivity.

For the European Union, this has been a major test and governments have overcome an early hurdle. Clearly, Greece needs to get its fiscal house in order. If that can be achieved and Greece remains in the union, the euro bloc should become stronger as a result. If they don't, obviously, it will be a failure. There is a remote chance that Portugal or even Spain could leave, but that would be a disaster for the euro area and I think the politicians will be willing to do whatever it takes to prevent that from happening.

What is the impact of a weak euro?

For U.S. companies with European end markets, the lower euro is of course a negative. By the same token, it's positive for European companies, especially those with exports. And it also means that U.S. consumers can benefit from lower prices and reduces pressures to raise interest rates.

In general, we are cautious about companies with major European market exposure.

What are your expectations for growth moving forward?

Overall, we are in the camp that growth in Europe will remain positive in euros, but negative in dollar terms. If there is evidence that Greece is on the right track and that the problem has been contained, that will be a big positive. We are concerned about economic prospects in the U.K. and Japan, where deficits are high.

What areas do you think should be avoided and what do you find attractive?

In general, we are cautious about companies with major European market exposure, particularly in the countries that have particularly acute fiscal problems right now—specifically, Greece, Spain and Portugal. Within Europe, we believe that companies that are active in emerging markets or are levered to the U.S. recovery have better prospects. We think that core Europe—particularly Germany—which is benefitting from a weak currency and low interest rates, offers good opportunities.

Although economic prospects in emerging markets are clearly stronger than in more mature regions; valuations there are also higher. We often find that developed-market companies with a major presence in emerging markets or driven by demand there are more affordable. We believe there are opportunities in the energy sector, particularly with the recent pullback. The BP oil spill is likely to result in tighter regulation, so companies with lower production costs are well positioned.

What worries you?

Aside from the risks we've already touched on, I think there is risk on the financial regulatory front. We have already seen larger capital requirements for banks, which certainly inhibits banks' ability to do business and may dampen business activity. We are avoiding investments in countries where regulation may be particularly onerous. On the other hand, there are plenty of activities that contributed to current problems that don't create economic value. So you can regulate them out of existence without impacting the broader economy.

What do you expect moving forward?

The days of the beta market appear to have passed.

Overall, we think that markets are likely to remain flattish but reward companies with strong fundamentals. In other words, there will be bigger difference between winners and losers. The days of the beta market appear to have passed.

UGO LANCONI

FX Strategist and Portfolio Manager
Global Fixed Income Team

The European governments have to come up with very strong answers for the markets.

CURRENCY*What's behind the euro sell-off?*

Over the last six months, attention has shifted dramatically from the debt and fiscal problems in the U.S. to similar issues in Europe. It has become clear that in order to resolve the structural problems that Europe now has, governments will have to implement very aggressive austerity measures by cutting public spending, which is likely to depress growth. In addition to the concerns surrounding indebtedness, the euro sell-off is partially a result of revised growth expectations in the euro area. Investors tend to prefer currencies with strong growth prospects and higher yields. And yields have fallen in Germany and other core European nations because investors have started to believe that the European Central Bank will keep rates on hold for much longer in order to stimulate growth and compensate for the impact of fiscal tightening.

How far can the euro fall?

Only a few months ago, the euro was very overvalued in relation to long-term measures like purchasing power parity, but no one seemed to care because investors were too concerned about the U.S. problems and even worried about the status of the U.S. dollar as a reserve currency. Now the euro has fallen from more than \$1.51 in December to around its long-term fair value of roughly \$1.20.⁶ The move has been driven by liquidation of euro long positions accumulated over the past few years and now appears a bit overdone, at least in the short term. On the other hand, if U.S. growth continues to outpace European growth, euro weakness versus the dollar could continue. At the same time, we shouldn't forget that many speculators are short the euro. You could have a couple of good headlines and short sellers might move to cover their positions, which could lead to some volatile price action.

What about the euro's role as a reserve currency?

The central banks' reserve managers are big players in the currency markets. Over the past 10 years or so, they have gradually diversified their reserves out of dollars, increasing their exposure to euros and to other major currencies. However, the U.S. dollar remains their largest holding. Recent volatility has probably caused central banks to slow this diversification process down. Eventually, I think the euro could reach low-enough levels for reserve managers to start selling dollars again. After all, the diversification process is a long-term dynamic and it is unlikely to stop for now. The speed of the diversification will depend on how things evolve in Europe.

What has to happen before reserve managers sell dollars in favor of euros?

The European governments have to come up with very strong answers for the markets. Thus far, they have been working very hard to restore confidence. Realistically, I would be very surprised if the Europeans did not use all the tools in their power to defend the single currency. It's in no one's interest to see a euro failure. It is technically possible that you could see one or two members get pushed out of the single currency but the Euro Zone will do everything it can to avoid it.

⁶Source: Bloomberg.

Unfortunately, the biggest problem in Europe is the lack of speed in the decision-making process.

The first priority is to avoid financial instability, and this was partially achieved through the Greek rescue package. The second priority is to implement credible medium-term measures to bring fiscal deficits to sustainable levels; in fact, Spain, Greece and Portugal have already introduced austerity measures. The third—and most difficult—priority is to develop meaningful ways for Europeans to cooperate on fiscal matters. That is a long-term process, but the current crisis is pushing them faster towards that goal. Unfortunately, the biggest problem in Europe is the lack of speed in the decision-making process. E.U. members still need internal approval for key decisions and for this reason prompt action is often not possible.

You've talked about the euro versus the dollar. What about other trades?

The euro was extremely overvalued versus a number of currencies and it has depreciated virtually across the board. By contrast, the currency that gained the most last year was the Australian dollar. Along with New Zealand, another commodity producer, Australia has benefited from booming Asian economies and from a pick-up in global growth. The euro is now starting to look attractive relative to the Australian dollar and the New Zealand dollar. EUR/AUD has been trading at all-time lows, just above 1.40.⁷ If you believe that Asia will slow down, these are very interesting levels.

The British pound is also starting to look undervalued from a long-term perspective, given that investors have sold the pound aggressively against all the major currencies over the past couple of years. The sterling moved from a record high of \$2.10 in late 2007 to around \$1.43 recently.⁸ In fact, the U.K. has already suffered from some of the same problems faced more recently by Europe and the U.S.—debt and particularly a large fiscal deficit. These problems have not yet been resolved but, now, with the Conservative-Liberal Democratic coalition, there is a good chance that a credible budget consolidation plan will be successful in improving the long-term structural issues. Additionally, we are starting to see signs of growth in the U.K., which I think should support the pound going forward. However, the downtrend is still in place and it may be too early for an investment there.

⁷Source: Bloomberg.

⁸Source: Bloomberg.

This material is presented solely for informational purposes and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation or solicitation to buy, sell or hold a security. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. Any views or opinions expressed may not reflect those of the firm as a whole. Third-party economic or market estimates discussed herein may or may not be realized and no opinion or representation is being given regarding such estimates. Any ratios or other measurements using a factor of forecasted earnings of a company discussed herein are based on consensus estimates, not Neuberger Berman's own projections. This material has been prepared by Neuberger Berman LLC on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. Neuberger Berman LLC has not sought to independently verify information taken from public and third-party sources and does not make any representation or warranty as to the accuracy, completeness or reliability of the information contained herein. Certain products and services may not be available in all jurisdictions or to all client types. Data is not representative of any Neuberger Berman investment product or service and does not reflect the fees and expenses associated with managing a portfolio. Indexes are unmanaged and are not available for direct investment. Unless otherwise indicated, returns shown reflect reinvestment of any dividends and distributions. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

A bond's value may fluctuate based on interest rates, market conditions, credit quality and other factors. You may have a gain or a loss if you sell your bonds prior to maturity. Of course, bonds are subject to the credit risk of the issuer.

Investing in foreign securities involves greater risks than investing in securities of U.S. issuers, including currency fluctuations, interest rates, potential political instability, restrictions on foreign investors, less regulation and less market liquidity.

The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials, including stocks that trade on the New York Stock Exchange.

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.

Treasury Securities are negotiable debt obligations issued by the U.S. government and backed by its full faith and credit.

Diversification does not guarantee a profit or protect against loss.

Neuberger Berman LLC is a registered Investment Adviser and Broker-Dealer. Member NYSE/FINRA/SIPC.

K0257 06/10 © 2010 Neuberger Berman LLC. All rights reserved.