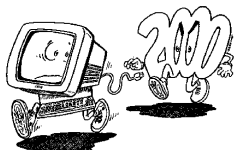


# CHARTWELL REVIEW

January 2010

**FOURTH QUARTER 2009**

Volume XVI, Issue No.4



## < ZERO DECADE



The quarter just ended brought down the curtain on the most difficult decade for US investors in many generations. We dub it the “< Zero Decade,” because the most heavily weighted asset class (based on market cap size) for most domestic institutional investors, US Large Cap stocks, produced substantially negative real returns on a cumulative basis.

The decade began with the Y2K frenzy, amid worries about a worldwide computer programming glitch (seems almost quaint). The decade ended amid worries the need to delever stretched balance sheets will prolong a global recession that is only now showing signs of relenting. Sandwiched in between were two of the longest and deepest bear markets the US has ever experienced.

Nevertheless, it was possible to make some money this decade, even with straight beta (market) investments, as the last column of Table 1 attests. You “*simply*” had to emphasize international stocks and global bonds. Far easier said than done for most US\$-based investors.

The other thing you had to do to make money last decade was to have faith. You needed to “walk into the light,” by re-balancing toward risk assets when fear was high (like just before we invaded Iraq in Q1 2003) or confidence low (like in the spring of 2009).

2009 ultimately proved to be an extraordinary time to own risk assets, especially high beta stocks. And, after some early gyrations, the 4<sup>th</sup> quarter represented yet another extension of the risk asset rally. We were a bit surprised by this, having expected a correction as investors took some profits and re-calibrated their views on future growth prospects. Thus, we would not chase risk assets at this juncture, and recommend adding to long-only equity allocations just on weakness. There is much uncertainty about 2011 and beyond.

**Table 1: Index Benchmarks**

<i>Market Index</i>	<u>Trailing Returns *</u>				
	<u>Q4 09</u>	<u>1 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>	<u>10 Yr</u>
S&P 500	6.0	26.5	(5.6)	0.4	(0.9)
U.S. Large-cap Stocks	6.1	24.2	(5.6)	0.2	(2.3)
U.S. Mid-cap Stocks	5.9	40.5	(4.6)	2.4	5.0
U.S. Small-cap Stocks	3.9	27.2	(6.1)	0.5	3.5
Foreign Stocks ( <b>devel</b> )	2.2	32.5	(5.6)	4.0	1.6
Foreign Stocks ( <b>emerg</b> )	8.6	79.0	5.4	15.9	10.1
T-bills	0.1	0.6	3.2	3.5	3.4
U.S. Aggregate Bonds	0.2	5.9	6.0	5.0	6.3
High Yield Bonds	6.0	57.5	5.8	6.4	6.5
Global Bonds, unhedged	(1.0)	5.8	7.5	4.8	6.8
<i>CPI, annualized</i>	3.2	2.7	2.6	2.7	2.6
Dow UBS Commodity	9.0	18.9	(3.8)	2.0	7.1
Chartwell Global 65/35	3.6	26.4	0.6	4.8	4.8

**Table 2: Average Mutual Fund Returns**

<i>Fund Category</i>	<u>Trailing Returns *</u>				
	<u>Q4 09</u>	<u>1 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>	<u>10 Yr</u>
U.S. Large-cap	5.8	30.7	(4.7)	1.0	0.4
U.S. Mid-cap	5.4	38.5	(3.3)	2.4	3.9
U.S. Small-cap	4.6	34.4	(4.7)	1.4	5.1
International Lg. Cap	2.6	32.6	(5.4)	4.2	2.4
International Sm. Cap	2.6	49.7	(5.6)	6.2	5.6
Emerg. Mkt. Equity	7.5	73.9	3.2	14.3	9.6
Balanced/Hybrid	3.6	23.3	(0.7)	2.7	3.3
General Bonds	1.5	16.1	5.1	4.5	6.0
Government Bonds	(1.2)	0.4	5.8	4.7	6.0
High Yield Bonds	5.4	45.0	3.7	4.7	5.0

\* Annualized trailing returns for periods ending 12/31/09.

## The US Economy Begins its Recovery

In December, the final estimate of 3<sup>rd</sup> quarter real GDP growth was released. Although revised downward to only +2.2% (“advance estimate” had been +3.5%), the report confirmed what we all sensed – after 18 months, the recession ended early last summer. Initial data of the “the rebound” was mixed, thus prompting much debate on the future course of the recovery (V-shaped? U-shaped? W-shaped?).

In January, the Feds issued their advance estimate of how much our economy grew in the 4<sup>th</sup> quarter. Although obviously subject to much possible revision, the headline number was very good. It is estimated real GDP grew at an annual rate of +5.7% in the quarter. The big driver was inventories declining by much less than they did in Q3 (yes, less of a negative is a positive for Washington statisticians). Table 3 breaks it all down.

**Table 3: Breaking Down 2009 Real GDP**

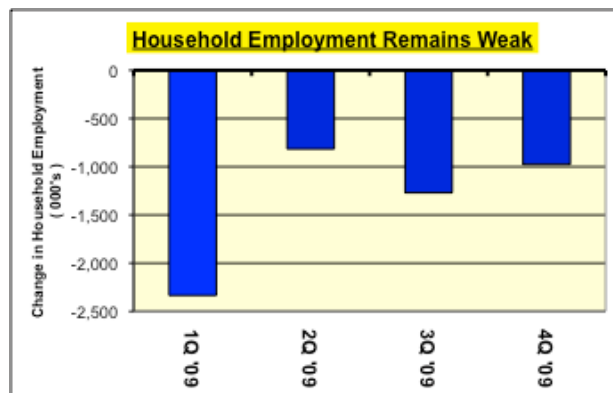
Factor	% Change from Preceding Period (seasonally adjusted at annual rates)			
	3Q '09	4Q '09	2008	2009
<b>Real GDP Growth</b>	2.2	5.7	0.4	(2.4)
<b>Nominal GDP Growth</b>	2.6	6.4	2.5	(1.2)
<b>Disposable Income</b>	(1.4)	2.1	0.5	1.3
Personal Consumption	2.8	2.0	(0.2)	(0.6)
Private Investment	5.0	39.3	(7.3)	(23.5)
<i>Fixed - Businesses</i>	(5.9)	2.9	1.6	(17.9)
<i>Fixed - Residential</i>	18.9	5.7	(22.9)	(20.4)
<i>Chg. In Inventories (\$)</i>	-\$139Bn	-\$34Bn	--	-\$86Bn
Exports	17.8	18.1	5.4	(9.9)
Imports	21.3	10.5	(3.2)	(14.2)
Government Spending	2.6	(0.2)	3.1	1.9

Together, 2009 and 2008 easily represented the country’s worst GDP growth experience in 30 years. In fact, you have to look back to 1938 for a greater decline than 2009’s. Reduced investment was the primary factor in this recession’s *depth*, with business and residential investment both declining at double-digit rates for an extended period. These declines finally abated in the 3<sup>rd</sup> and 4<sup>th</sup> quarters, especially the inventory shrinkage factor. Nonetheless, overall business investment only accounts for 8% of current GDP, and residential investment for 2.5%. This decade, these figures peaked at 18% and 6%, respectively. Consumer spending now accounts for 71% of GDP, and government expenditures for 13%. Both figures are at 30-year highs.

The Congressional Budget Office projects a \$1.35T fiscal deficit for FY2010, following last year’s deficit of \$1.4T. As a proportion of our economy, these deficits are as large as any other period in our history. Perhaps the biggest risk investors face is the uncertainty concerning what impact this fiscal policy will have on our future. It’s uncharted territory from here on.

The employment picture remains grim. Non-farm payrolls declined by 208,000 in the 4<sup>th</sup> quarter, after dropping 600,000 in the 3<sup>rd</sup>. The lower figure was interpreted as a positive sign, although it had no favorable impact on real earnings for the quarter (they were flat, and down 1.6% for the year). Unfortunately, the household survey reported another 1 million fewer persons employed at quarter’s end. Altogether, over 8 million fewer people are working than two years ago.

**Figure 1: 2009 Employment Losses**



Which leads us to a <Zero Decade factoid: Private sector employment was lower at the end of 2009 than it was at the end of 1999. After adding 19 million jobs in the Nineties, domestic private sector employment declined 1.5mm in the Zeroes. Manufacturing employment declined by 6mm persons. Yet, government employment increased by over 2mm in each decade.

Adjusted for seasonality, general consumer prices continued to rise at a moderate, but increasing, pace. They advanced at a 3.2% annual rate in Q4, and were up 2.7% year/year for the period ending Dec 2009. In 2008, the CPI rose 0.1%. Ex-food and energy, the index rose just 1.8% in 2009, and 1.8% in 2008, but the contributing factors were very different.

Producer Prices have not been nearly as benign in this early recovery period. PPI-Finished goods rose at a 9% annual rate in the quarter, and advanced 4.4% in 2009, after falling 0.9% in 2008. PPI-Crude materials rose 12.6% for the three months ending December. After plunging in 2008 and early 2009, crude goods prices steadily and sharply increased the second half of 2009.

On a favorable note, the Institute for Supply Management reported that activity in the manufacturing sector expanded in December for the fifth consecutive month, with the forward-looking PMI index rising to 55.9%, its highest reading since April 2006. The new orders and production indices have been very strong during this period. In contrast, the ISM’s December report on non-manufacturing sectors was not nearly as robust, but the index reading of 50.1% did indicate growth for the third month in the past four.

## Treasury Yields Rise

The Treasury bond index lost 1.3% in the quarter (2.6% in December alone), and was off 3.6% in 2009. For most of the year, record net issuance by Treasury had been met with strong demand, despite ongoing concerns that foreign investors would be dissuaded from buying by weakness in the US Dollar. Treasury yields finally began to back up, as new demand was not able to keep pace with new issuance. The evident shift in sentiment/demand, even as the US\$ staged a strong 4<sup>th</sup> quarter rally, should concern us greatly. Unprecedented fiscal deficits = unprecedented new bond issuance, which will affect future term interest rates.

The bellwether 10-year Treasury bond's yield rose 40 bps in the quarter, to 3.8%, its high for the year. The 30-year bond's yield rose to 4.64%, nearly 200 bps higher than last year's panic low. The front end of the curve remains anchored by the Fed at 0%. Thus, while the yield curve has steepened to a 20-year high (see Figure 3), the yield on the overall Treasury Index is just 2.46%. The Treasury Dept. emphasized short maturities in its 2009 funding program, keeping current interest costs down at the expense of sharply increased rollover risk.

The Aggregate Bond index struggled to post a modest 0.2% return in the quarter. Corporate credits continued to benefit from the rotation away from Treasuries, and rallied into year-end. BBB-rated credit advanced 2.3%, and its simple spread over Treasuries dropped another 70 bps (see Figure 2). Financial sector bonds were the strongest performers, with an excess return of 3.8%. High yield bonds were once again the strongest performing credit sector, as increased confidence emboldened investors to further bid up prices.

CMBS recovered strongly in the quarter, as did other sectors of the non-agency MBS market, including prime and Alt-A residential MBS. Residential delinquencies remain high, but show some signs of stabilizing, and loss severities are reported lower. CMBS securities face very challenging commercial real estate fundamentals, yet were the best performing investment grade sector in Q4 and for all of 2009. Demand support for the sector is coming from very high spreads and a series of Fed policy related initiatives – including TALF and PPIP.

The Fed purchased over \$1 trillion of agency MBS in 2009, which was double net supply. This strong net bid has driven spreads for on-the-run MBS issues to the lowest levels this decade. If the Fed makes good on its promise to exit the mortgage bond business, MBS are likely to widen versus Treasuries, and underperform.

The investment-grade credit market ended 2009 in a much different position than when the year began. The spread on the BarCap US Corporate Index stood at 172 bps as of December 31<sup>st</sup>, compared with 218 bps on September 30<sup>th</sup> and 555 on December 31, 2008. Yet, the corporate sector remains attractive, in relative terms, if one adds in the high yield and bank loan sectors.

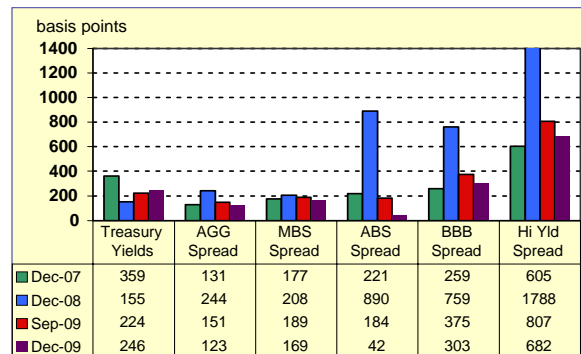
**Table 4: Primary Bond Sector Returns**

Bond Index	4Q '09	1 year	3 years
<b>US Aggregate Bonds</b>	<b>0.2%</b>	<b>5.9%</b>	<b>6.0%</b>
3-mo. T-bills	0.0	0.2	2.4
US Treasury, long	(5.3)	(12.9)	5.8
U.S. TIPS	1.8	11.4	6.7
Agency MBS	0.6	5.9	7.1
CMBS	3.3	28.4	1.2
ABS	1.3	24.7	3.6
Inv. Grade Credit	1.0	16.0	5.7
High Yield Credit	6.0	57.5	5.8
Non-US Global, Hedged	0.3	4.3	5.1
Non-US Global, Unhedged	(1.8)	6.8	8.2

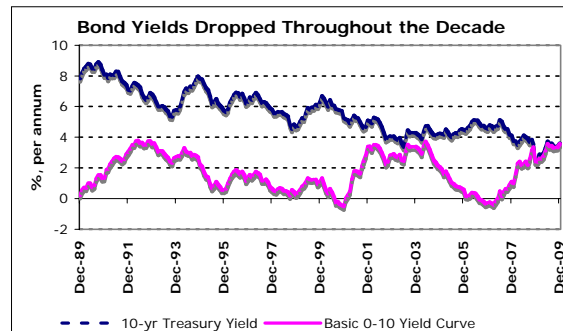
**Table 5: Bonds Staged a V-shaped Recovery**

<i>Excess Returns versus Treasuries, duration-adjusted (%)</i>			
Bond Sector	4Q '09	2009	2008
<b>Aggregate Bonds</b>	<b>1.0</b>	<b>7.5</b>	<b>(7.1)</b>
US Agencies	0.4	2.9	(1.5)
Agency MBS	0.8	5.0	(2.3)
Comm'l MBS	3.7	29.6	(32.7)
Asset-Backed bonds	1.7	25.0	(22.2)
Invest. Grade Credit	2.7	19.9	(17.9)
High Yield Credit	6.9	59.6	(38.3)
Primary Non-U.S.	2.0	7.3	(6.4)
Emerging Markets	4.0	38.0	(28.4)
AAA Subprime	8.8	18.0	(40.1)

**Figure 2: Because Credit Spreads Plunged in 2009**



**Figure 3: With Treasury Yields at Multi-year Lows**



## Domestic Equities – still going . . . . .

Domestic equity markets continued their furious rally into the 4<sup>th</sup> quarter. All of the major indices posted positive gains, led by the Top 200 Growth stocks. The S&P 500 gained 6% in the quarter, and closed 2009 at 1115 (up 26.5% for the year). The tech-heavy NASDAQ (+45.4%) significantly outperformed broad market indices, because gains on stocks in the information technology sector, whether small or large, far outpaced those of every other sector (60+% gains).

The S&P's advance for the year was its highest since 2003, but fell considerably short of midcap stocks (+40.5%) and very slightly trailed small-cap stocks (+27.2%). The size effect (*Smaller > Larger*) was generally reversed in the 4<sup>th</sup> quarter, as investors rotated toward stocks that might have been left behind in the "great beta rally of 2009." The Top 200 stocks were up 6.1%, while the Russell 2000 was up "only" 3.9%.

Per Table 6, the value effect (*Value > Growth*) was once again not observable during the 4<sup>th</sup> quarter. Instead, growth outperformed value at every major point along the market cap curve, except microcaps. However, if we consider the last two years as a whole (a steep market decline followed by a sharp rebound), the picture is changed. Value indices have produced *less* downside capture, with one very major exception - large cap value stocks. This size/style sector entered 2008 dominated by 3 industry groups – financials, energy, and industrials. Stocks in these sectors, especially large-cap financials, have been the weakest performers over the past two years. Actively managed accounts that underweighted these sectors, outperformed their peers.

Financial services stocks were once again the quarter's laggards, with every other GICS sector posting positive returns (see Table 7). Citicorp and BofA led the way down. Information technology accounted for one-third of the S&P's advance, from a combination of exceptional return (+11%) and heavy weighting (20%). Microsoft, Google, Apple, IBM, and Oracle led that sector, accounting for over 50% of its net contribution. Health Care was the second-largest contributor in large-cap space, led by big pharma stocks Merck, Pfizer, and J&J. Despite evidence the domestic consumer continues to be extremely challenged for discretionary cashflow, the Consumer Discretionary sector again posted very strong returns. Over the past two years, consumer stocks have outperformed all other sectors, even as our domestic unemployment rate soared above 10%.

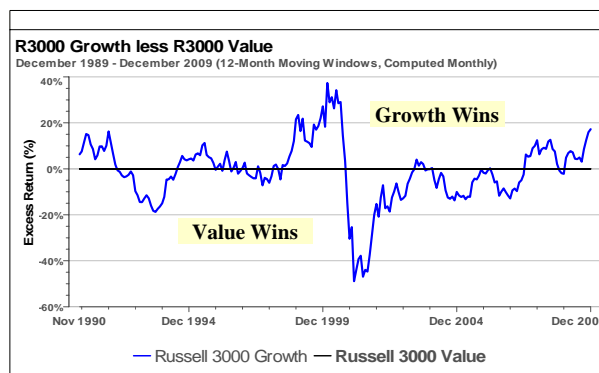
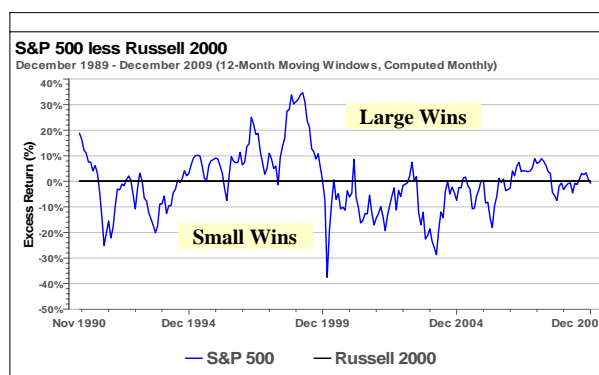
Among small-cap stocks, contribution to return was diffused across sectors for the quarter, although marginally led by tech and industrials (the top performing materials sector accounts for only 4.8% of small caps, as most natural resource companies are large-cap). Small growth was led by consumer and tech stocks, which account for nearly 50% of the market cap. Small-value was driven by financials and industrials.

**Table 6: U.S. Equity Market Size/Style Returns**

	4Q '09	2009	Trailing Periods	
			2-Years	5-Years
<b>Growth</b>				
Top Cap	8.4	34.0	(7.4)	1.4
Mid Cap	6.7	46.3	(9.8)	2.4
Small Cap	4.1	34.5	(9.1)	2.0
Micro Cap	(0.8)	39.2	(12.2)	(3.1)
<b>Value</b>				
Top Cap	3.8	14.6	(14.4)	(1.1)
Mid Cap	5.2	34.2	(9.1)	2.0
Small Cap	3.6	20.6	(7.4)	0.0
Micro Cap	(0.2)	17.5	(12.5)	(3.5)

**Table 7: U.S. Sector Returns**

Sector	Large-cap Returns (%)		Small-cap Returns (%)	
	4Q '09	2-Yrs	4Q '09	2-Yrs
Cons. Disc.	8.5	(2.9)	5.3	(8.3)
Cons. Staples	5.0	(1.6)	4.1	(4.5)
Energy	5.6	(13.5)	6.1	(17.8)
Financials	(2.8)	(26.1)	1.4	(14.0)
Health Care	8.8	(3.3)	5.1	(4.4)
Industrials	5.1	(15.1)	5.0	(13.6)
Info Tech	11.0	(3.6)	6.4	(4.9)
Materials	8.3	(10.0)	8.0	(8.5)
Telecom Svcs	8.1	(13.6)	7.2	(16.6)
Utilities	6.7	(11.0)	7.4	(7.2)



## A Positive Decade for International Equities

Fourth quarter international returns were muted in comparison to the year's spectacular first nine months, as investors struggled to reconcile the V-shaped global *equity market* recovery with a questionable global *economic* recovery. Further, the US Dollar strengthened in the quarter, after consistent declines earlier in 2009. In net \$ terms, the EAFE+Canada index gained 2.2% for the quarter and finished the year up 31.8%. Local returns were 3.3% and 25.3%, respectively. Better earnings, continued accommodative monetary and fiscal policies, and *reasonable* (no longer cheap) valuations all contributed to equity appreciation. Even Dubai World's near default did not slow local markets.

Both the quarter and year were generally favorable for European stocks (see Table 8). Strong local markets and the rising Euro saw \$ returns reach 36% for 2009. However, concerns over the "weak links" of Europe are rising (Portugal, Ireland, Italy, Greece and Spain). The Greek stock market fell 21% in local terms during the 4<sup>th</sup> quarter, while posting a 21% advance for 2009. Ireland dipped just 1% in the quarter, but it was a laggard in 2009 (+8.8%). Differential local market performance was notable in 2009, ranging from Finland (+7.7%) to Belgium (+53%) and Norway (+54%).

The Pacific region *ex-Japan* gained 5.2%. Japan's one-year return of 6.3% was the worst amongst developed international markets – and very different from ten years ago when Japan's 61.8% annual return was the top performer. Japan's trailing 10-year compound return for this decade is (3.7)%, one of the lowest in the EAFE index (Finland and Ireland did worse). Singapore rose 9.8% in the quarter, as GDP and trade figures confirmed a strong recovery from 2008. Australia advanced 5%. Aussie stocks gained 76% in US\$ terms last year, with currency effects adding 40% to local market gains.

Improving commodity prices drove the global materials sector to top performance, with an 11.9% return. The global energy sector gained 6.9%. Both sectors were stronger abroad than in the US. After lagging during the first three quarters, defensive health care and consumer staples sectors gained 7.7% and 6.6%, respectively. These two defensive sectors also posted the best two-year record, which is just what the playbook would have predicted. Outside the US, the technology sector declined (2.6)% on news of earnings downgrades, while the recovering financial sector was stymied by political issues and dropped (4.5)%.

From a style standpoint, international value stocks outperformed growth stocks for the year (34.2% versus 29.4%), which was just the opposite of US markets. Financials are the largest sector in the value index. Despite the fourth quarter pullback, financials were one of the top performing international sectors for the year. From a size standpoint, small cap stocks outperformed their large cap peers for the year, gaining 46.8%.

Developing markets returns continued to dominate those of developed markets. The MSCI Emerging Markets index gained 8.6% for the quarter and 78.5% for the year. The BRIC index (Brazil, Russia, India and China) gained 10.5% and 93.1%, respectively. Russian and Indian markets doubled, and the Chinese market advanced 62%. Taiwan was up 8% in the quarter and 79% for the year. However, the Latin America region took top honors over both periods. Brazil was the top performing emerging market in 2009, soaring 128% in US\$ terms. The worst emerging markets last year were the Czech Republic (+26.5%) and Poland (+40%).

In a turnabout from the first nine months, a weighted basket of EAFE currencies declined 1.1% relative to the US dollar in the 4<sup>th</sup> quarter. The euro fell 1.8%, while the British pound rose 1%. The worst performing currency was the Japanese yen, which dropped 3.8%.

**Table 8: International Markets Returns**

<i>(index level = net)</i>	U.S. Dollar Return %		Local Currency Return %	
	4Q '09	2009	4Q '09	2009
<b>EAFE + Canada</b>	<b>2.4</b>	<b>31.8</b>	<b>3.3</b>	<b>25.3</b>
- EAFE Growth	4.2	29.4	5.2	22.0
- EAFE Value	0.3	34.2	1.6	27.5
- Europe	3.2	35.8	4.0	27.7
- Pacific, ex-Japan	5.2	72.8	3.8	45.6
- Japan	<b>(2.8)</b>	<b>6.3</b>	<b>1.1</b>	<b>9.1</b>
- United Kingdom	7.0	43.3	5.9	27.6
<b>Int'l Small Cap</b>	<b>0.5</b>	<b>50.8</b>	<b>1.3</b>	<b>42.0</b>
<b>Emerging Mkts</b>	<b>8.6</b>	<b>78.5</b>	<b>7.2</b>	<b>62.3</b>
- EM Asia	6.7	73.6	5.7	67.5
- EM Europe & ME	10.3	77.7	11.0	68.8
- EM Latin America	12.4	103.8	9.7	62.9
- EM BRIC	10.5	93.1	9.2	71.8

**Table 9: Global Sector Returns**

<i>as of Dec. 31, 2009</i>	Primary Market (Large Cap)		Extended Market (Small Cap)	
<i>(GICS Sector)</i>	4Q '09	2 Years	4Q '09	2 Years
Cons. Discretionary	5.8	(7.4)	2.8	(12.4)
Cons. Staples	6.6	(2.5)	0.7	(5.8)
Energy	6.1	(10.9)	6.0	(13.1)
Financial Services	(3.4)	(21.7)	(1.4)	(16.9)
Health Care	7.7	(2.4)	2.3	(5.9)
Industrials	3.5	(14.7)	1.5	(14.1)
Info Technology	7.8	(6.6)	3.8	(6.5)
Materials	11.9	(9.3)	7.2	(8.3)
Telecom Services	4.0	(10.8)	6.6	(11.4)
Utilities	2.3	(13.3)	6.6	(6.5)

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## Strange Goings On

That's the answer my mother frequently gave out, to address certain questions of *certain people*. It often saved her time and aggravation.

We've highlighted some entries in tables 1 and 2. There were some strange goings on last year with actively managed US large- and small-cap, and diversified bond, portfolios. The average mutual fund crushed their nominal benchmarks *after* fees and expenses, especially the bond managers. This is a rarely observed phenomena over any 12-month period. One of the explanations for the stock funds is market cap drift. The index of mid-sized companies outperformed both large-cap and small-caps. Portfolios that drifted down, or up, in average cap-size, were rewarded. In bond funds, the trade was to overweight credit bonds and underweight Government bonds. The BarCap Aggregate is weighted 28% Treasuries and 13% Government-related. Let China and the Fed buy the underperforming govovies; most core and core plus managers loaded up on credit bonds or credit default swaps. The US investment grade credit index returned 18.7% last year. If you were a core bond manager with the flexibility to overweight credit bonds, especially including some high yield paper, and you choose not to, your clients suffered.

## Heads Up

Despite suffering greater losses during the bear market years, international stocks finished the <Zero Decade with a higher annualized 10-year return than domestic large cap stocks. The MSCI EAFE index gained 1.6% versus a (0.95)% p.a. result for the S&P 500. Further, any dedicated exposure to emerging markets would have handsomely bolstered the international result (see Table 1). This was quite a turnaround from the Nineties, where the trailing 10-year annualized return for the S&P 500 was 18.2% (1926-2009 average return is 9.8%) and the result for the MSCI EAFE index was less than half that, at 7.3%. What a difference a decade makes!

This demonstrates to us that initial conditions matter. Ten years ago, the S&P 500 index stood at 1469, with an irrational trailing PE of 28.4x. A-rated corporate bonds were yielding almost 8%. Operating earnings were decidedly *not* depressed, having risen almost 17% in 1999. Earnings would rise another 9% in 2000. But, it didn't matter. By the time 2001 rolled around, the S&P index had declined 10%, because investors realized that 2001 operating earnings would hit the wall. They did, falling 30%. An expensive market had become even more so, and market prices declined well into 2002.

The S&P index closed 2007 at 1468, the same level as 1999, despite trailing operating earnings which were 60% *higher*. A-rated bonds were yielding 6.25%. Said differently, it took eight years (2000-2007) to scrub the market's PE down from its irrational level of 28.4x.

Conversely, 2009 reported operating earnings for the S&P will be very close to \$56/sh, *up* 13% from 2008's kitchen sink write-off induced \$49.50/sh (but *down* 32% from 2007). The trailing PE is 19.9x, which is not really irrational with A-rated bonds yielding 5%.

As we noted last quarter, "to sustain the (equity) rally, the markets need to see earnings recover." No rocket science. We continue to believe that a sustainable recovery will be built on the critical transition from *stimulus* driven growth to growth driven by *real demand*, translating into both revenue and earnings growth. This will not be without some drama, especially in demand-constrained locales like the US and UK.

Yet, initial conditions are not altogether unfavorable. The S&P index is priced to a 19.9x PE, based on trailing earnings most analysts think will rise substantially from current levels. Consensus is \$75/sh in 2010, which seems like a stretch (+35% in a soft global economy?). Let's guess it takes three years to get to \$75. Even so, 19.9 times \$75 = 1493, which is still +34% from 1115.

So, we still like a "meaningful level of equity risk exposure" (consultant-speak) in diversified portfolios with a long-term investment horizon. Especially since the BarCap Aggregate bond index is trading at a "PE" of 27x (that's what a 3.69% yield equates to).

The issue is how to best source this equity risk exposure? Corporate earnings have generally exceeded expectations, but from drastically reduced levels caused by the Great Recession. A slow economic recovery will constrain growth opportunities, particularly in major developed markets. The tide will not carry all ships higher at the same rate (see Germany vs. Greece). Given these circumstances it would not be surprising to see markets and sectors pause and retrench, but at different times and at different rates. We expect market correlations will move *lower* over the next 3 years.

Thus, we see return/risk benefits in three approaches:

- (a) much higher non-US equity allocations than investors have historically been comfortable with;
- (b) globally diversified credit, including junk bonds, and bank loans. Leave (mostly) the government bond investing to other governments;
- (c) higher allocations to long/short portfolios, across both the equity and credit spectrum.

Market values have had their V-shaped recovery, but most of the global economy has not. Government policy risk is very high. There will be short-term volatility. Further, the "left tail risk" associated with meaningful long-only equity allocations can't be diversified away with simply more long-only equity.

**Sell high, buy low. See you next quarter!**

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