

Investment Commentary

JUNE 29, 2009

At the midway point of the year, we thought it would be a good time to take a look at the 12 predictions we made in January to see how we are faring:

1. **The US economy faces its first nominal GDP decline in 50 years.** This prediction seems more than likely to come true. With negative nominal growth, corporate profits and consumers' balance sheets remain under pressure, meaning more credit issues are likely to come.
2. **Global growth falls below 2% for the first time since 1991.** There has been some improvement in the emerging economies, but by year-end it appears likely that global growth will be somewhere in the 0.5% to 1% range.
3. **Inflation falls close to zero in many developed countries, but widespread deflation is avoided.** Thanks in large part to aggressive global policy actions, we have been able to avoid widespread deflation as inflation indices are trending around the zero line.
4. **The US Treasury curve ends 2009 higher and steeper than where it began.** These trends have emerged in the first half of the year as we have seen a widespread improvement in confidence levels and investor risk appetite.
5. **Earnings fall by a double-digit percentage again in 2009, the first back-to-back drop since the 1930s.** In retrospect, it appears that estimates were cut too much earlier in the year, but we still expect to see overall earnings down by a double-digit percentage in 2009. We also expect to see some recovery in earnings by the end of this year.
6. **High yield, municipal and investment-grade corporate bond spreads narrow in 2009.** At the beginning of the year, spread levels were discounting depression-like scenarios, which, thankfully, did not come to pass. Spreads still remain high by historical standards and, in our opinion, have further to narrow.
7. **US stocks record a double-digit percentage gain in 2009.** We still expect to see some back-and-forth in stock markets, but we are holding to our year-end target of around 1,000 for the S&P 500, which would be consistent with a double-digit gain for the year.
8. **US stocks outperform European stocks while emerging markets outperform developed ones.** The latter half of this has certainly come true so far this year. Time will tell whether the United States is able to outperform Europe.
9. **Energy, healthcare and information technology outperform utilities, financials and materials.** At present, a basket of energy, healthcare and IT stocks has outperformed a basket of utilities, financials and materials stocks, and we expect this trend to continue through the end of the year.

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10. Stock market volatility remains elevated as periodic double-digit percentage rallies and declines occur. We have already seen a double-digit decline and rally, and believe volatility levels will remain relatively elevated.
11. Oil and other commodities bottom and move higher by year-end as emerging market economies begin to recover. We think commodity markets have already bottomed as the emerging market economies have begun to recover.
12. The US federal budget deficit soars past \$1 trillion as the government continues to grow. At present, most are now expecting the deficit to easily exceed \$1 trillion and to approach \$1.75 trillion or higher.

In general, most of our predictions are currently on track, and we'll conclude by reiterating our beginning-of-year forecast, which remains a good summary of our views:

The investment debate is likely to center around the issue of debt-induced deflation versus policy-induced reflation. Our guess is the latter will win out, but the timing, path to get there and ancillary consequences are highly uncertain. While we are likely in the longest and deepest recession of the post-World War II period, record massive fiscal and monetary stimuli are likely to eventually turn the US and global economies around before the deleveraging forces promoting deflation overwhelm us. Policy needs to be consistently aggressive and there is not much room for error.

Therefore, 2009 is likely to be marked by negative real growth, weak nominal growth and significant earnings declines. When recovery finally comes, it is likely to be muted as deleveraging on the part of the consumer and the financial sector will take many years. If our assessments are correct, 2009 will see a slow, but noticeable, return to "risky" assets over "safe" assets. We believe an equity market bottoming process began in October. Bottoming processes typically take months to complete with re-tests of lows possible. However, increasingly attractive valuations, coupled with high degrees of skepticism supported by massive sideline cash, lead us to believe that equities will have a positive, albeit volatile, year.

We expect the United States to outperform Europe, and emerging markets to outperform developed ones. In our scenario, interest rates rise gradually and spreads narrow. Commodity prices should bottom and start moving higher. As we had hoped for 2008, perhaps 2009 will be the year when reflation and liquidity begin to beat credit woes and fear.

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