



November 7, 2010

Oh, What a Week!

Let's count the ways:

1. Historic midterm elections with Republicans gaining 60 seats in the House of Representatives; such a Republican win was last seen in 1938, and such a shift in party seats was last seen in 1948 when Democrats won 75 seats.
2. Unprecedented monetary policy in the US, with the announcement of \$600 billion for round two of quantitative easing (QEII) with a willingness to change the size of the purchase program as necessary.
3. An equity market rally that drove the S&P 500 to September 2008 levels right after the Lehman collapse.
4. A rebound in a number of global Purchasing Managers Index surveys in manufacturing and services pointing to more robust growth in 2011.
5. A US employment report with 151,000 new jobs and upward revisions to data from the prior two months.
6. Continued strong third quarter earnings reports that underscore the strength and resilience of corporate America.

What is the significance of all that has transpired? We will begin with the key takeaways from the midterm elections and their implications for policy making, namely the extension of the Bush tax cuts, free trade, job stimulus, and future deficit reduction. We will then review the Federal Reserve Board's announcement with respect to the specifics of the next round of quantitative easing and its implications for interest rates, equities and the US dollar. A wrap-up of the third quarter earnings reports and their implications for our equity views will follow. We will then provide a global economic update and conclude with investment implications.

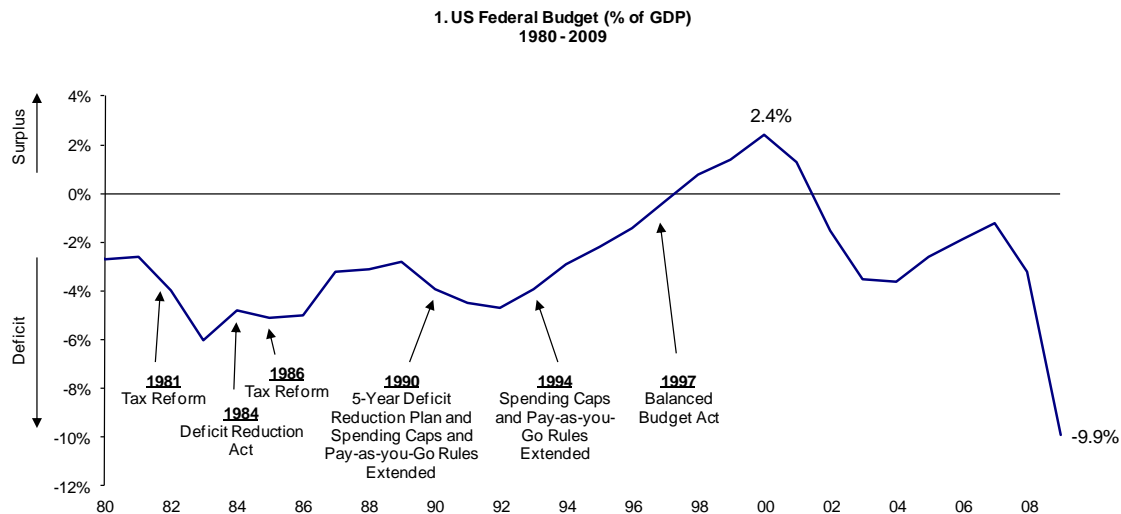
US Midterm Elections

In the US midterm elections, Republicans gained 60 seats in the House and 6 seats in the Senate, resulting in a dramatic shift in Washington's power base. We turned to two political experts, Kenneth Mehlman and Norman Ornstein, as guest speakers on our client call¹ this past week. They emphasized the importance of President Obama's two options: "reach across the aisle" to Republicans, just as former President Clinton eventually did after the 1994 midterms, or follow Former President Truman's less compromising style after the 1946 midterms. Which path President Obama may choose is difficult to predict, but it will certainly be critical to policy over the next two years. The lame duck session may provide some insights:

- First, will President Obama negotiate (and negotiate quickly) on the Bush tax cuts that expire on December 31st? In the absence of an extension, Americans will effectively face a \$450 billion tax increase, representing a sizable hit to their disposable income and a potential drag of 1.5-2 percentage points on GDP growth. So, it is not surprising that President Obama stated Wednesday, "that the single most important thing... that has to be done during the lame duck session -- is making sure that taxes don't go up on middle-class families next year."² That said, he stopped short of endorsing an extension of the tax cuts for the highest earners, a key sticking point for Republicans.

- Second, will the President return from his trip to Asia and the upcoming G20 conference willing to move forward with Congress on free-trade agreements with South Korea, Colombia, and Panama? Many political experts see this as an area of potential compromise and beneficial to reaching the goal of doubling America's exports by 2015.
- Third, will President Obama and Congress work together to create a jobs stimulus bill?
- Finally, will the White House respond favorably to entitlement spending cuts or changes if they are recommended by the bi-partisan Fiscal Commission on December 1st?

While visibility on these issues may shed more light on Washington's ability to overcome gridlock in the next two years, a divided government is not necessarily bad. The likelihood of additional sweeping reforms like Healthcare and Financial Regulation that contributed to the significant uncertainty that paralyzed businesses has diminished. Instead, areas of potential compromise may dominate the agenda, such as infrastructure investment programs, free trade to promote US exports, and energy policy. Also, five of the last six major fiscal reforms occurred under a split government (where each party controlled at least one house of Congress or the White House), showcasing the potential for bi-partisan success. (Exhibit 1)



Another interesting point is that US equity returns in the three months following a midterm election exceed the returns achieved in the same time frame of non-midterm election years. Specifically, equity markets have risen by 8.4% on average in the three months following midterm elections, compared with 2.0% in those same three months of non-election years.

The QEII Cruise Sets Sail

Competing with the midterm elections for news headlines, the Fed embarked on its second round of quantitative easing (i.e. asset purchases). Since signs of QEII emerged in late August, risk assets have rallied. US equities are up over 17%, developed market stocks have rallied over 9%, and emerging market equities have rallied over 14%. High yield bonds have rallied over 6%. Interestingly enough, 10-year Treasuries are practically unchanged, but real yields have fallen as inflation expectations based on Treasury-Inflation Protected Securities (TIPS) yields have increased from 1.6% to 2.1%. The US dollar has dropped 7% on a trade-weighted basis and, in line with their recent negative correlation to the US dollar, both oil and gold have rallied 18% and 13% respectively.

The much-anticipated announcement came on Wednesday this week – \$600 billion in new investments and \$250-\$300 billion in reinvestments. The total size of the program seemed consistent with market expectations, while the \$75 billion monthly pace through June 2011 seemed modestly slower than expected.

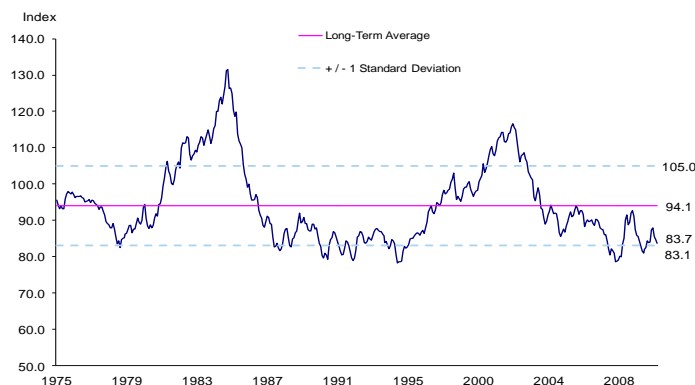
So, what does QEII mean for asset markets?

Let's start with bonds. Despite talk of a potential bond bubble, the historically low 2.54% 10-year Treasury yield can certainly go lower. In fact, if the Fed makes purchases as announced, it alone could absorb approximately 75% of estimated Treasury issuance. Since other Central Banks, households, and financial firms will also be buying Treasuries during this period, demand may easily outstrip supply, causing bond prices to rise and yields to fall.

Turning to the equity markets, it seems the mantra thus far has been “don't fight the Fed.” In a *Washington Post* op-ed piece, Federal Reserve Chairman Bernanke explicitly wrote “Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending.”³ On this point, it is worth highlighting an observation we made in our 2010 Outlook. Namely, that the top third of the income distribution in the US now constitutes roughly 60% of discretionary spending, and importantly, stock ownership represents five times more of their net worth than that of the bottom two-thirds. The upshot is that spending patterns today are more closely linked to equity prices than in previous cycles, a fact that may well have been factored into Chairman Bernanke's decision for QEII.

In terms of the US dollar, while it may move modestly lower in the short-term, we think concerns over its potential collapse (i.e. another 20% decline) are overdone for several reasons. For one, we think the risk that current Fed policy results in hyperinflation is low given the tremendous slack in the economy - unemployment is hovering near 10%, capacity utilization rates are 74.7% versus their long-term average of 81%, and inflation expectations, which are a key driver of actual inflation, are just 2.7% over the next 5 years according to the Michigan Survey. Moreover, we don't expect the Fed to monetize the US debt burden. In 1946, the Gross Federal Debt to GDP ratio stood at 122% (versus 83% at the end of 2009) and fell to about 60% over the course of thirteen years driven by economic growth and fiscal reform, which we expect the US to eventually pursue. Finally, it's important to bear in mind that the US dollar has already fallen significantly, dropping some 40% since its 2002 peak. As such, the US dollar is arguably undervalued, already trading at the lower end of its historical valuation range relative to its major trading partners (Exhibit 2). In the past, valuation levels similar to today have presaged a modest rise in the US dollar in the medium term. Thus, while we could certainly see more US dollar volatility in the months ahead, we could characterize a US dollar collapse as a low probability event.

2. USD Real Trade Weighted Index (vs. Main Trading Partners)
Through September 2010



Third Quarter Earnings and Equity Market Implications

While it is tempting to attribute the recent equity rally to QEII and the midterm elections alone, such a characterization is unjust to the underlying strength of corporate fundamentals. Indeed, with some 90% of S&P 500 earnings now reported, roughly 74% of companies beat EPS expectations, while two-thirds topped sales expectations. Of equal importance, these top line results represent fundamental improvement, as close to 80% of firms reported positive yearly sales growth. In fact, non-financial S&P 500 revenue grew 2.5% from last quarter and close to 10% compared to last year, vastly outgrowing US GDP growth in the quarter.

The operating leverage prevalent over the last year remained a centerpiece of the current quarter, as 10% revenue growth generated roughly 35% EPS growth, and each dollar of incremental sales resulted in about 35 cents of additional profit. Over two-thirds of companies saw their margins improve, a performance usually seen three years into a profit recovery cycle. In short, despite significant economic slack in the US, S&P 500 companies are generating earnings at an annual rate around \$88.00, a level within 4% of the peak EPS reached in mid-2007.

Against this strong earnings backdrop, we remain comfortable with the 2010 S&P 500 targets we published in January of this year, namely a year-end range of 1150-1225. While the current trajectory of earnings does imply some upside risk to our \$82-87 operating EPS forecast for 2011, our good case scenario, to which we attribute a 20% probability, contemplates earnings in the high \$90s. As such, our central case remains a year-end 2011 S&P 500 range of 1225-1300.

Just as in the US, earnings strength is notable for Japanese firms. Companies representing approximately two-thirds of Japanese market cap have now reported, and earnings have grown by 10.6% from last quarter. These companies—many of whom are exporters—achieved this earnings growth despite a nearly 5.5% appreciation of the Yen (JPY). Results have surpassed both company guidance as well as analysts' expectations, but equity markets have not responded. In fact, Japanese equities have underperformed global equity markets, particularly so during the rally in equity markets over the last ten weeks.

However, we continue to recommend that clients overweight Japanese equities. A large driver of Japan's recent underperformance seems to be continued JPY appreciation, which we think will eventually reverse course given our view that the JPY is overvalued, particularly relative to the US dollar. Moreover, we believe that the market's fundamentals, which are coming in stronger than expected despite JPY appreciation, will ultimately prevail, and Japan will outperform other regions as earnings continue to recover toward their long-term trend.

With earnings season nearly in the rear view mirror, the market's focus is likely to shift from micro to macro, with heightened sensitivity to global economic data, just as we saw during the August downdraft following a strong Q2 2010 earnings season. So, what are global economic data indicating?

Global Economic Update

After a period of extremely mixed economic data throughout the summer, the recent data have been more favorable globally. As a result, fears of a double dip recession have receded.

We'll start with the positive. Third quarter GDP grew 2.0% quarter-over-quarter (qoq) annualized in the US, 3.2% in the UK, and 9.6% (3Q10/3Q09) in China. Moreover, recent Purchasing Manager Index/ISM surveys, which lead economic growth by 1-2 quarters, continue to point to expansion. In fact, October manufacturing surveys in the US, UK, Euroland, and China all indicate that activity increased at a faster rate than during September. Importantly, the improvement was driven by new orders, not simply

increasing inventories, a positive sign for the manufacturing outlook. In the US, the ISM level of 56.9 stands above the historical average of 53.0. While US consumer confidence remains somewhat range-bound at relatively low levels, in Germany both consumer and business confidence are at multi-year highs and the unemployment rate is at an 18-year low. The strong economic data and some inflationary pressure have led some emerging markets to hike interest rates recently: China announced its first rate hike since 2007 and India announced its sixth rate hike of the year.

In Japan, data are still pointing to a slowdown, but the Bank of Japan has responded. Business surveys have generally revealed significant concerns about the future of growth and leading indicators have softened. As a result, the Bank of Japan recently reduced its growth outlook by 0.1% to 1.8% but also announced a plan to buy Yen 5 trillion of a variety of assets (not just government bonds). According to the Bank of Japan Governor Shirakawa, these efforts are to “provide relief to the financial markets and have a positive effect on corporate sentiment.”⁴

Of course, some data in the US and abroad are better characterized as stable, as opposed to improving per se. In the US, housing starts and sales have improved from the summer lows but remain depressed; initial jobless claims are range-bound but nevertheless elevated; and the unemployment rate is generally unchanged but still high. Payroll additions of 151,000 positively surprised Friday, and the prior 2 months of data were revised strongly upwards, but the pace of job creation remains modest. And, core inflation is positive and has stabilized at or below 1% in the last several months, spurring the Fed’s decision for QEII given its dual mandate of high employment and price stability.

Investment Implications

Reflecting on the events of the last week and the trajectory of recent data, we seem to be facing less political and economic uncertainty. The US midterm elections have resulted in a more divided Washington, but one which is less likely to shock the market with sweeping legislative reforms or regulations. As a result, businesses may feel more comfortable deploying capital through hiring and capital spending. The Fed has proven its willingness to support the economic recovery, and we believe that the near-term benefits of QEII to growth and sentiment far outweigh risks around the Fed’s eventual exit strategy. And, economic data are generally improving, earnings data remain robust, and fears of a double dip recession have receded.

Of course, a policy mistake could still occur, most notably failing to extend at least the middle-class Bush tax cuts. In addition, sources of uncertainty and risk still exist globally and investor attention on any one of several issues could spark a short-term sell-off. For example, concerns around the fiscal profiles of Ireland and Portugal have resurfaced; debates about whether Greece will eventually need to restructure its debt continue; geopolitical tensions including those in the Middle East and Afghanistan and those related to terrorism have not diminished; and US and Chinese relations around currency movements remain tenuous.

Against this backdrop, how should clients position their portfolios? With QEII setting sail, we think investors should continue to hold a core of investment grade fixed income, but remain underweight. We believe that there are opportunities to enhance returns by shifting a small portion of holdings into Emerging Market Local Debt and US Corporate High Yield. Emerging Market Local Debt offers exposure to emerging markets that have more favorable fiscal profiles than developed economies, that stand to benefit from continued capital inflows, and that are likely to see currency appreciation as central banks target inflation with interest rate hikes. US Corporate High Yield spreads continue to more than compensate investors for expected defaults and recoveries. In terms of global equities, we see the greatest value in Japanese equities (specifically funded out of investment grade fixed income). In our view, Japanese equities already discount the weaker state of economic data but do not discount the ongoing recovery in corporate fundamentals. With respect to clients’ long-term strategic positioning, we

recommend those clients who can withstand potential short-term downdrafts to stay invested in a diversified portfolio when the market is fairly valued, as it is now. For those who have not participated in the recent rally, we believe building slowly towards strategic weights is an appropriate strategy.

¹ A replay of our client call this week to discuss the US Midterm Election Results and Market Implications remains available (please contact your Private Wealth Advisor). The call featured guest speakers, Kenneth Mehlman and Norman Ornstein. Kenneth Mehlman is currently the Head of Global Public Affairs at Kohlberg Kravis Roberts & Co. He formerly served as Chairman of the Republican National Committee and as Campaign Manager of President Bush's 2004 re-election campaign. Norman Ornstein is a Resident Scholar at the American Enterprise Institute for Public Policy Research. Please contact your Private Wealth Advisor for replay information.

² President Barack Obama. "Press Conference by the President." The White House, Washington D.C. 3 November 2010.

³ Bernanke, Ben S. "What the Fed did and why: supporting the recovery and sustaining price stability." *The Washington Post*. 4 November 2010.

⁴ Otsuma, Mayumi. "BOJ Confronts Two-Decade Land Slump With J-REIT Plan." Bloomberg. 4 November 2010.

Sources: Investment Strategy Group, Goldman Sachs Global Investment Research, Bloomberg, DataStream, United States Department of the Treasury, The Federal Reserve, The Congressional Budget Office, The Washington Post, The New York Times.

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