Outlook

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Take Stock of America

We believe that 2010 will see the continuing emergence of fast-growing economies such as China and India, but we don't think their success will cost the US its leadership position. The underlying strength and influence of America is intact.

For Private Wealth
Management Clients

Take Stock of America

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The greatness of America lies not in being more enlightened than any other nation, but rather in her ability to repair her faults.
- Alexis de Tocqueville[1]

It seems that a day doesn't go by without some commentary about the rise of the East, particularly China, and the fall of the West, particularly the United States of America. Captivating newspaper headlines about China such as "The Decade the World Tilted East," or "Wheel of Fortune Turns as China Outdoes West," or "China Makes Gains in its Bid to be the Next Top Dog" stand in sharp contrast to those about the US: "The Dollar Adrift," "The Message of Dollar Disdain," "The Coming Deficit Disaster."[2]

Many market observers are quick to point out that the financial crisis and deep recession of 2008-09 have dealt a fatal blow to US hegemony. They note that the US budget deficit, at over 10% of GDP in fiscal 2009, has compounded the twin problems of a leveraged consumer and unencumbered entitlement programs like Social Security, Medicare and Medicaid. The US economy, says their argument, will be burdened by this debt overhang for the foreseeable future and grow at sub-par levels, and the descent of the US will be expedited by the unwillingness of the politicians in Washington to make the tough decisions to cut government spending.

Thus, they say, the US's dominating influence ends, and that of China – which is sitting on an estimated $2.3 trillion of central bank reserves, has weathered the global financial crisis with a 8% GDP growth rate in 2009 and has a current account surplus of 6.5% of GDP – begins. China's centrally managed governing process will be effective in maintaining high growth rates, the argument goes, which will cause China to become the largest world economy sometime in the next 20 or so years, thereby removing the US from the economic perch upon which it has sat since the late 19th century. »

Just in case the flurry of articles and research reports throughout 2009 touting the rise of China and the fall of the US were not enough to influence all rational thinking about allocating assets, two new books were published to reinforce these changing hegemonies. The titles are self-explanatory: *When China Rules the World: The End of the Western World and the Birth of a New Global Order* by Martin Jacques and *When Giants Fall: An Economic Roadmap for the End of the American Era* by Michael J. Panzner.

This cascade of information inevitably affects investors. As Nobel Laureate Professor Daniel Kahneman and the late Amos Tversky said: A proposition can become irresistible simply by the media repeating it. Assets have flown out of US equity funds and dollar-based investments into emerging market funds; assets have also been allocated into gold funds as a safe haven against a weaker dollar. We are surprised at the extent to which clients have asked about whether they should allocate some of their "sleep well" money into more risky emerging market debt. Based on the latest data available, about $42 billion has been taken out of US equity mutual funds and non-commodity exchange traded funds while $80 billion has been put into emerging market funds and $10 billion into gold funds.[3] (For our views on commodities, please see the January 2010 Investment Strategy Group Insight publication, *Commodities: A Solution in Search of a Strategy*.)

As we read through the articles and books proclaiming the end of the US's reign, we are reminded of the late 1970s and 1980s, when similar themes were pervasive: the US could do no right while Japan and the Asian Tigers could do no wrong. Books like *Japan as No. 1: Lessons for America* by Ezra Vogel and *The Enigma of Japanese Power* by Karel Van Wolferen epitomized the thinking of the time.

Vogel wrote in his book about "the decline of our confidence in government ... our difficulty in coping with problems such as ... unemployment, inflation and government deficits," and suggested adopting the Japanese model due to its "substantial progress in dealing with problems which seemed so intractable in America." The March 12, 1979 cover of *BusinessWeek* captured the mood of the times: a tear trickling down the face of the Statue of Liberty and a headline stating "The Decline of US Power."

It all sounds familiar: the rise of the East and the fall of the US. Well, since its peak in December 1989, the Japanese equity market has declined 73%, while US equities have rallied 219%; the Japanese economy has had an annual growth rate of 1% while the US economy has grown at 2.5% a year. Clearly, neither the optimism about Japan nor the pessimism about the US was warranted. And the re-allocation of assets out of the US into Japanese assets was not fruitful.

We believe that history is repeating itself. The current pessimism about the US economy, unemployment, inflation and government deficits, as well as the concerns about the reserve status of the dollar, are similarly unwarranted. China may well experience impressive growth over the next several decades – in fact, we expect it to. But that growth, in our opinion, will not come at the expense of the US.

Our view is based on two premises. The first is an extension of what we presented a year ago in our 2009 Outlook, where we stated that this financial and economic crisis was "not as unprecedented or uncharted" as it appeared. Clearly, the recession was deeper than the 3.1% decline of 1973-74, and the equity market decline was greater than either the 48% drop of 1973-74 or the 50% fall of the 2000-02 bear market. But the credit market did not fare as poorly in the recent crisis as it did in the 1973-74 period, and it recovered much more rapidly. And unemployment, which may well continue to rise, is not expected to exceed the 10.8% peak reached in 1982.

Given our view – held a year ago and maintained today – that the current crisis is not as unprecedented as it was claimed to be at the depths of the recession, our first premise states that the US economy will recover along the paths of past recoveries. We will examine the path of the current recovery and compare it to past recoveries in the next section. We will demonstrate why we believe this recovery is likely to have more in common with past recoveries than most people expect. Furthermore, with an economic recovery underway, we will show how the budget deficit can be addressed without resorting to inflation to reduce the debt burden. We will show, in other words, how the current crisis has not dealt a fatal blow to the US as the preeminent economic and geopolitical power.

The second premise is driven by a rigorous assessment of the various factors that, in combination, have accounted for the unique success and dominance of the US over the last century. A careful review of the data has led us to conclude that these factors are all intact; and in fact, no one country is even close to approaching the US on this range of factors.

So, again, this crisis has not dealt a fatal blow to US hegemony. And our clients should not tilt their assets in a well-diversified global portfolio further away from the US in fear of such a decline.

It is important to note that the waning of the US has been a topic of serious debate multiple times, and in all cases, the US has recovered and maintained its preeminence. Indeed, the case mentioned above, of Japan challenging the US in the 1970s and 1980s, was just one of six such episodes in the post-World War II period. In 1988, the late American political scientist Samuel Huntington outlined five in a *Foreign Affairs* article titled "The U.S. - Decline or Renewal?"[4] More recently, Josef Joffe, publisher-editor of the German weekly *Die Zeit* and visiting professor at Stanford University, reviewed the current and therefore sixth prophesy of the US's decline.[5]

Reviewing these episodes shows several variations on a theme. In the late 1950s, as a result of Soviet missile launches and the success of Sputnik (the first orbital satellite), the declinists, as they are called, stated that the Soviet Union was establishing an unchallengeable lead in missiles and outpaced the US in producing scientists and engineers; US education and military power were in decline. Lo and behold, four decades later, the Soviet Union is no more. In the late 1960s, the declinists said that the bipolar world was coming to an end and Europe and Japan would emerge as equals of the US and the Soviet Union. Lo and behold, the world became unipolar, with the US as the sole, preeminent power. The 1970s saw a number of events – the Kent State University shootings in 1970, the Arab Oil Embargo in 1973, Watergate in 1974 (which resulted in President Richard Nixon's resignation) and the US defeat in Vietnam in 1975 – that led to a general feeling of malaise about US power and US moral standing, and subsequent pressure on the dollar. In the 1980s, the competitive threat came from Japan. And now, many are expecting that China will replace the US as the preeminent power of the 21st century.

Let's look at US strengths in three critical areas – the economy, the military and general measures of prosperity – and see if any other major country comes close. We have leveraged the work done by the Legatum Institute, a London-based organization that has designed a prosperity index to measure factors beyond economic wealth – such as innovation, education, governance and democratic institutions – which are important to the long-term sustainability of the economic and military might of a country.

Economic Strength

At $14.3 trillion as of December 2009, the US accounts for 24.9% of world GDP. Its economy is 2.8 times larger than the next largest economy, Japan; 3 times larger than the third-largest economy, China; and 4.4 times larger than the fourth-largest economy, Germany. To put these numbers in perspective, the United States has a higher GDP than the next three largest economies combined. The only entity to come close to the US is Euroland, a union of 16 countries with a common currency and monetary policy. A reminder that Euroland includes countries that have their own significant economic challenges will quickly dispel any notion that it will challenge US's economic preeminence anytime soon.

For a different perspective, we can look at GDP per capita. The US GDP per capita is $46,400. That is not only the highest among major world powers, it is also one of the highest overall; only a few small countries (such as Luxembourg with a population of 500,000, Norway with a population of 4.8 million, Qatar with a population of 1.2 million and the Netherlands with a population of 16.8 million) top it. Among major countries, the next highest GDP per capita is that of France at $42,000, Japan at $39,600 and Germany at $39,400. Among major emerging market countries, Russia's GDP per capita is $8,800, Brazil's is $7,700, China's is $3,600 and India's is $1,000. The US's GDP per capita is nearly 13 times that of China and 46 times that of India.

Of course, some point out that with certain growth rate and currency appreciation assumptions, China's overall GDP will surpass that of the US in the next 20 or so years. Even then, though, China's GDP per capita will probably be about a quarter of that of the US. Furthermore, even the Chinese themselves are realistic about the difficulties of sustaining such high growth rates without major structural reform over the next decade or so. Some of the reforms that Chinese officials have identified are:

- financial reform (including a more developed capital market system, market-driven interest rates and a convertible floating exchange rate);
- economic reform (including a shift away from an export-oriented and investment-led economy to a domestic consumption-oriented economy; a difficult task because while consumption has grown 7.5% per year between 2000 and 2008, it has dropped as a percentage of GDP from 42% to 36%);
- enterprise reform and privatization to reduce state support of the private sector (currently, the government has a stake in 17 of the largest companies in the MSCI China Index with an ownership interest that amounts to about 16% of the total market capitalization in China; that compares to less than 1.5% in the US, even after the government's increased involvement during the recent crisis);
- price reform (the government, for example, has controls on the prices of fuel, electricity, water and land); and
- social reform to introduce health insurance and a pension system so that households save less and consume more (the current savings rate, which includes corporate savings through retained earnings, is about 51%).

This is a long list of Herculean reforms that China has embarked upon. While it is highly likely that China will successfully implement these reforms over the next decade or two, it is too early to prophesize that China will bump the US from its economic perch when such reforms are in their infancy. We quote Chinese Premier Zhou En-Lai who was reported to have remarked to Henry Kissinger in 1976 when asked for his opinion of the French Revolution, "It is too soon to tell."

Military Strength

While the gap between total GDP and GDP per capita of the US and that of other countries is quite significant, the gap in military power is even greater. As Josef Joffe has pointed out, "the United States plays in a league of its own." Based on 2008 data from the Stockholm International Peace Research Institute, the US spends $616 billion or about 4.2% of its GDP annually on its military, accounting for close to half of the world's total military spending. Even the sum total of the next 14 countries (including Australia as the 14th) does not add up to the US's annual outlay. Number 2 on the list is China at $84.9 billion (though China's National Bureau of Statistics' official military budget stands at $67 billion, or 1.4% of its GDP). It is interesting that as the debate about the end of the US century and the beginning of the Chinese century continues, the Chinese are contemplating building an aircraft carrier nearly a century after the US built its first aircraft carrier, USS Langley, in 1922.[6] It would seem that for a shift from a uni-polar to a bipolar or multipolar world to occur, the balance of world military power has to undergo some seismic shifts of its own. For the foreseeable future, such shifts do not appear on the horizon.

Recent articles have talked about the drain on the US military of the Iraq and Afghanistan wars as well as the broader war on terror. They claim that these wars are weakening the US and will contribute further to its decline. Again, we think it is important to have some perspective on the military history of the US since World War II. The US prevailed during the Cold War against the Soviet Union. At the time, the Soviet Union's stockpile of nuclear warheads topped 40,000, with over 10,000 of them sitting atop intercontinental strategic missiles capable of targeting major US and European cities. The Vietnam War that lasted from 1965 to 1975 cost $686 billion in 2008 dollars and 58,000 servicemen were killed. Given that the US has survived multiple wars and gone on to prosper, it is hard to imagine that Iraq and Afghanistan will derail the US to the extent that it is no longer the major economic and military power in the world.

Prosperity

Let's now turn to the softer factors that contribute to US's preeminent status. Since its inception over 200 years ago, the US has had an extremely resilient and dynamic economy and a stable political system. It is an open society and an open economy with immigration as a core principle of its existence. Its technological achievements, in aggregate, outpace those of any other country. The question is how can one measure the factors that account for such resilience, dynamism and stability and use them to make comparisons between the US and other countries. The Legatum Prosperity Index attempts to capture some of these factors. This index is comprised of 79 different variables, which are distilled into nine different sub-indexes; each country's score is an equal weight of the sub-indexes. The nine sub-indexes are economic fundamentals, entrepreneurship and innovation, democratic institutions, education, health, safety and security, governance, personal freedom, and social capital.

Among major countries, the US ranks number one. Overall, it is ranked ninth out of 104 countries after Finland, Switzerland, Sweden, Denmark, Norway, Australia, Canada and the Netherlands. The only country with a GDP of greater than $1 trillion in the top nine is Canada at $1.3 trillion. Japan, the world's second largest economy, is ranked 16th. Brazil is ranked 41st, India 45th, Russia 69th and China 75th.

What are some tangible examples that account for the US ranking? Education is a good place to start. Among the top 50 universities in the world as ranked by the 2009 *Times of London* Higher Education ranking, 18, or 36%, are American universities; eight, or 15%, are UK universities; and six, or 12%, are Australian universities. One, Tsinghua University, is Chinese.

In terms of research and development, the US spent about $377 billion on R&D based on the latest data available from the Organisation for Economic Co-operation and Development (OECD); the next highest number is $148 billion by Japan, followed by Germany at $84 billion and France at $54 billion. Again, to compare these numbers to those of major emerging market countries, China is at $49 billion, Russia and Brazil are at $14 billion each and India is at $8 billion. The US spends 4.4 times as much as all the BRIC countries combined on research and development. Money in, money out. Take Apple's iPod as an example. Researchers at the Paul Merage School of Business and the Personal Computing Industry at the University of California, Irvine indicate that about 5% of the overall economic value from iPod productions is retained by the manufacturer of the hardware, in this case, China, with the balance going to the "designers, retailers and suppliers of sophisticated components." Add in applications and other software, and the bulk of the value created and then captured is overwhelmingly American.[7]

Let's look at the number of Nobel Laureates. Since the inception of the Nobel Prize, the US has garnered 320, compared to the UK, the next highest-ranking country, at 116. Russia has 23, India 9, China 6, and Brazil has none at this time. Over the last decade, 46% of Nobel Laureates have been US-based winners. We say US-based only because some of winners live in the US but are not US citizens – a reminder of the brain drain and immigration that occurs all over the world with some of the greatest talent settling in the US. Interestingly, Robert Lucas, a Nobel laureate in economics, argues that the clustering of talent is the primary driver of economic growth.[8] It seems that given the size of the cluster in the US, it will be many decades before any country shifts the technology and innovation balance away from the US.

There is substantially more that can be said about the soft factors that contribute to US's preeminent status. John Steele Gordon devotes a 450-page book, *An Empire of Wealth: The Epic History of American Economic Power,* to the topic, covering the US's national territory with fronts on both the Atlantic and Pacific Oceans in a world of global trade, to its rich natural resources, to its borders with two friendly countries. The book addresses the rule of law and importance of personal liberty and safety as an incentive for entrepreneurial spirits to start new companies, build new products and create their own wealth. It talks about a system of government where, if one group of politicians doesn't address the issues at hand, the electorate votes that group out of office and selects a new set of officials. It goes on to talk about the diverse ethnicities of the country and the favorable demographics. Countries such as Japan, Russia and those in Europe face declining populations, while even China is expected to see its population level off by 2030, according to the United Nations Population Division. The US is the only developed country expected to have a growing population.[9]

So as you worry about your US-based investments, further declines in the dollar and the US's burgeoning debt and loose monetary policy, it is worth remembering Alexis de Tocqueville's insight from almost 200 years ago. His words still ring true: The US has ample economic wherewithal, political might and prosperity factors to repair her current faults.

The Shape of Recovery

As we have written before, we believe that this recovery, and its impact on financial markets, can be better understood in the context of past recoveries. With that in mind, what does history tell us about the forward path of the US economy?

What Goes Down, Must Come Up … But How Much?

While there are few immutable laws in economics, an apparent candidate is the strong historical symmetry between the depth of a US economic contraction and the strength of its subsequent recovery, as shown in Exhibit 1. In fact, given the 3.8% GDP decline in this cycle, blindly applying this historical relationship would suggest growth close to 8% this year, significantly higher than the 2.7% consensus expectations. Thus far, the economy is following this historical trajectory, in spirit if not exact magnitude, as Q4 2009 growth appears to be tracking north of 4%, up substantially from the prior quarter's 2.2% result.

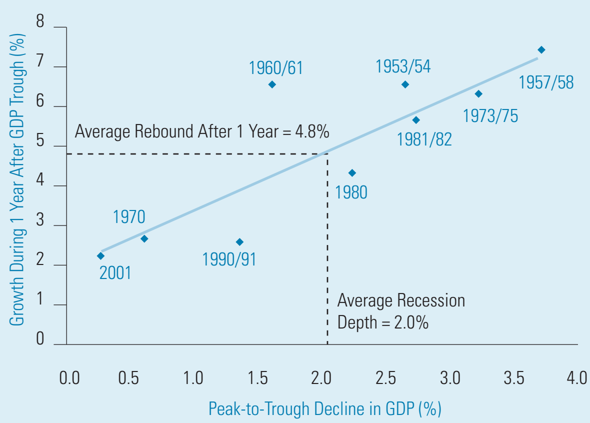
That said, there are good reasons to believe this recovery will be more tepid than history would suggest. A recent International Monetary Fund (IMF) study found that recessions associated with a financial crisis tend to have more muted recoveries, on the order of 2% in the year following the recession's end. In addition, two of the three typical engines of recovery growth, namely consumption and residential investment, face larger than typical headwinds in this cycle. Their potential drag on growth is material, as consumption typically contributes 3.7 percentage points to real GDP growth in the first year of recovery, while residential investment contributes about 0.8 percentage points. Inventory restocking, the third recovery driver, typically contributes roughly 0.8%.

A Benchmarking Exercise

Of course, to forecast such a muted recovery is tantamount to saying "it's different this time," a cardinal sin of investing. Which begs the question: How unique has this crisis been? As shown in Exhibit 2, the truly unique aspect of this crisis has been the magnitude of the government's response. In contrast, the decline in equity prices, home prices and the employment rate has been quite consistent with previous banking crises. Moreover, the recent 65% advance in US equities since the March 2009 low closely mirrors the 63% nine-month advance seen after another

Exhibit 1: Real GDP Growth in the Year Following Recession End

Deeper recessions have historically been followed by stronger recoveries. In contrast, the shallower the recession, the weaker the recovery.

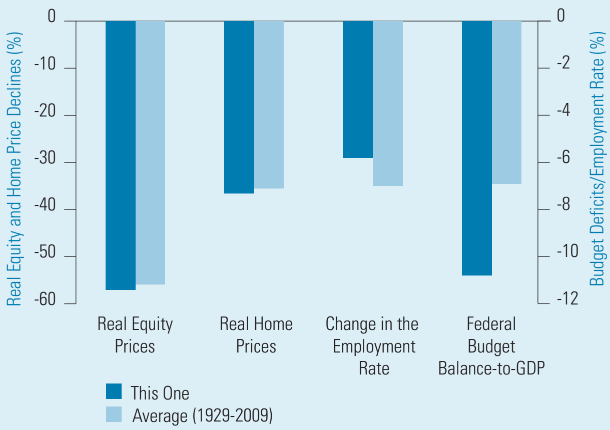


Based on US recessions during 1950-2009

Source: Department of Commerce (Bureau of Economic Analysis), Investment Strategy Group

Exhibit 2: Financial Crisis Severity: Today's vs. Historical Episodes

While the current crisis looks similar to previous financial crises on several metrics, a primary difference this time around is the large magnitude of government support.

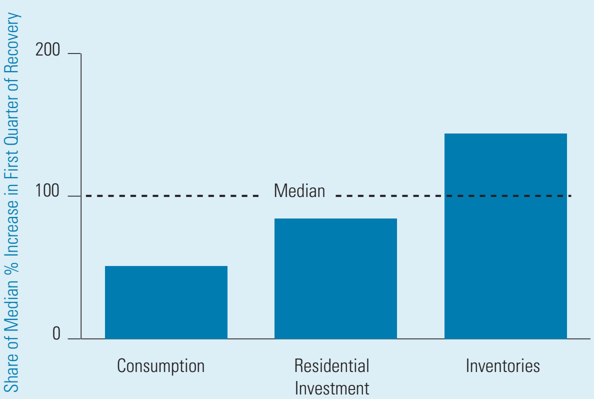


Includes most recent crisis and the following 14 global precedents: Argentina (2001), Colombia (1998), Finland (1991), Hong Kong (1997), Indonesia (1997), Japan (1992), Korea (1997), Malaysia (1997), Norway (1987), Philippines (1997), Spain (1977), Sweden (1991), Thailand (1997) and U.S. (1929).

Source: Investment Strategy Group; Empirical Research Partners Analysis, Reinhart, C.M. and Kenneth S. Rogoff, 2008; "The Aftermath of Financial Crises," Working Paper, Bureau of Labor Statistics; Standard & Poor's; International Monetary Fund.

Exhibit 3: Benchmarking the Key Drivers of Past US Recoveries

Relative to the comparable point in previous recoveries, inventory restocking is tracking ahead, residential investment is roughly in line while consumption is lagging. All three are within the range of historical outcomes.



Data as of December 22, 2009

Based on US recessions during 1950-2009
Source: Investment Strategy Group, Datastream

very deep recession in 1981-82. In all, much of what has occurred thus far has actually been with historical precedence.

Turning to Exhibit 3, we benchmark the current value of the three historical drivers of US GDP to their level at this point in previous recoveries. While some variables are below and others above previous cycles, the more important observation is that a recovery seems to be taking root, and each variable is at least within the range of historical outcomes. In fact, it appears the potential contribution from inventory restocking could be ahead of previous episodes, given the extent of the drawdown. The one lagging variable – and arguably the most important one – is consumption. Clearly, given its 70% contribution to GDP, the path of consumption is critical to one's investment outlook and positioning.

Consumption…the Lynchpin

The history of financial crises has not been kind to consumption, as lost jobs, lack of credit availability and the desire to repair personal balance sheets conspire to depress spending, even after other measures of growth improve. Our own view has this flavor, as we expect only mild growth in private consumption of around 2%. Nevertheless, the accuracy of this forecast will ultimately depend on the trajectory of employment, net worth and housing, as each has strong historical linkages with consumption. Turning first to employment, whether the current recovery follows the script of the 1990-91 and 2001 recessions, which saw muted employment growth, is a crucial consideration. In our view, it is premature to declare the current recovery "jobless."

Our relative optimism stems from a review of several leading labor market indicators. Importantly, the Conference Board's Employment Expectations Index and initial jobless claims, both leading indicators, turned in early 2009. Initial jobless claims, in particular, have fallen some 30% from their April 2009 high, placing their pace of improvement well ahead of the roughly 10-20% declines seen at comparable points in the last two "jobless" recoveries. The implication is that the unemployment rate may peak soon, if it hasn't already, given that initial claims usually lead it by around seven months. This notion is corroborated by The Conference Board's Employment Expectations Index, as it troughed in March; it typically leads the peak in the unemployment rate by nine months. Other leading employment indicators, such as corporate earnings, credit market spreads, temporary hiring and manufacturing hours worked also show gains consistent with an improving labor market. To this end, the return of private sector services employment to positive growth in November after two years of consistent losses was very encouraging, particularly since almost 70% of US payroll employment is concentrated in this category.

We are also encouraged by the stabilization in housing, which has important implications for consumers' net worth, and provides a positive tailwind to residential investment's contribution to GDP. As mentioned above, the rebound here is roughly tracking the historical analogues already. However, there is potential for upside, particularly since residential investment fell more than 56% from its peak over the last 14 quarters, substantially more than the typical recessionary decline of 20%. More importantly, we have started to see stabilization in the housing markets that epitomized the excesses in this cycle. To wit, just four states, namely Florida, California, Arizona and Nevada, accounted for 75% of the nationwide home price decline and still represent roughly half of all mortgages with negative equity. Encouragingly, sales volumes in these areas have risen about 60% from the trough. In turn, this surge in volume has stabilized prices, with median home prices up roughly 20% in California in 2009 and up 6% from the trough nationally. Just as the housing crisis originated in these four states and emanated to the rest, we think the recovery here will ultimately reverberate nationally. In this spirit, it is welcome news that nationwide existing home sales rose in July for the first time since 2005 and have advanced strongly since.

The interplay between employment and housing could also have implications for the foreclosure overhang, which many highlight as the Achilles heel of the housing recovery. Recent research based on loan-level mortgage data shows that negative equity and loss of employment together precipitate about three-quarters of all foreclosures.[10] As such, the turn of leading labor market indicators and the recent stabilization in the housing market are noteworthy. Already, with just a small improvement in national home prices, the share of mortgages with negative equity has declined from a peak of roughly 33% in Q2 2009 to around 22% currently, a significant reduction.

In our view, this cycle also has a few unique factors working in its favor. The first reflects the potential for a rebound in durable goods spending, as the collapse here has detracted more from economic growth than during any other recession in the modern era. According to data from the Federal Reserve Board, US consumer spending on durable goods (e.g., appliances, automobiles, etc.) is coming dangerously close to falling below the imputed depreciation expense of those goods. In other words, consumers are literally waiting to the very end of a good's life to replace it. The same is true for public companies outside of the commodities sector. This dual collapse in capital outlays has created a large pool of liquidity, which represents a future source of spending power. Indeed, the combined free cash flow of consumers and public companies over the first three quarters of 2009 was 7.5% of GDP, a level last seen in 1982. The implication is that such anemic levels of capital expenditures are unlikely to persist and should resolve in favor of increased spending.

The second factor has to do with the health of the marginal consumer in this cycle. Today, the top third of the income distribution in the US represents roughly 60% of discretionary spending, making this group's attitudes vital in understanding the consumption outlook. For them, deleveraging is not a major headwind, as debt equates to just 6% of their assets vs. 42% for the bottom two-thirds. In addition, their balance sheets are more equity-heavy, with stock ownership representing five times more of their net worth than that of the bottom two-thirds. In fact, households led by those 55 and older, a heavy weighting in the top third, hold almost 70% of all US households' equity holdings.

The upshot is that spending and savings patterns are more closely linked to equity prices than in previous cycles. Indeed, the volatility in this group's spending reflects the equity exposure of their balance sheets, as the largest spenders cut their charges by five times more than others during the market downturn, according to data from American Express. Moreover, University of Michigan surveys showed that the confidence of this group plunged further than those of lesser means as the stock market fell, a first in the modern era. As such, the recovery in global equities since the trough should disproportionately benefit this group's net worth, creating a potential upside bias to their consumption going forward.

Against these relative positives, the trajectory of savings rates remains a wild card to the consumption outlook, especially given its recent substantial increase from 0.8% to 4.4%. Intuitively, consumers look to offset declines in their net worth by increasing their savings, which can, in turn, temper their spending. The historical relationship between net worth and savings suggests the current savings rate should be somewhere between 4% and 8%. The good news is that we have pierced the bottom of the range. The critical questions facing investors now are where we settle in the range and also how quickly we reach that destination.

On this debate, there are several points worth keeping in mind. For one, the improvement in consumer net worth seen in Q2 and Q3 2009 and likely to continue in Q4 on the back of further equity gains and stabilizing home prices should temper the tailwind to rising savings rates. Second, according to some interesting analysis by Macroeconomic Advisors, led by former Federal Reserve member Larry Meyers, for savings rates to revert back to the high end of the historical range would require a significant *permanent* reduction in net worth and/or transfer payments (e.g., unemployment benefits, etc.). With asset markets recovering and the current administration's agenda supporting *increased* transfer payments, neither seems a likely outcome. Lastly, analysis by Empirical Research Partners, a portfolio strategy firm, led them to conclude that "much of the rise in savings is attributable to [financially] unconstrained, higher income households that absorbed a big hit to wealth later in life." If this thesis is true, the recovery in the equity markets may dampen a further rise in the savings rate, given this group's equity-heavy balance sheet.

Our View on the US Recovery

Ultimately, we expect US real GDP growth will be better than what's followed other financial crisis recoveries, but flatter than the recovery from a typical recession. As such, our forecast calls for 2.5-3.0% growth this year, with risk skewed to the upside. This growth will be supported by residential investment growth of 10-15% and a stronger than typical inventory rebound. Given this economic recovery, we expect the 10-year Treasury yield to normalize, settling within our 4.25-4.75% forecast range. As discussed in more detail in the next section of the report, we expect core inflation of 1.0-1.5% in 2010, with headline inflation of around 1.75-2.25%.

It is also worth noting that credit availability should not hamper our recovery forecast. What matters for GDP growth is not the amount of credit outstanding, but its rate of change. On this point, the pace of banks' loss recognition in this cycle is noteworthy, as part of what elongates recoveries following financial crises is the persistent drag of credit losses on banks' appetite to lend, as was the case with Japan in the 1990s. With roughly two-thirds of estimated full-cycle credit losses already taken, that drag should abate much faster than in previous crises. Indeed, both the price and the availability of credit have improved in recent months.

Lastly, while a recovery in the US appears underway, it is admittedly difficult to separate the purely cyclical forces of improvement from those created by the government's fiscal and monetary spending. Many assert that this recovery is not self-sustaining because it will only last as long as government stimulus continues. We don't agree. In our view, whether the economic growth seen thus far is primarily stimulus-based or not is less important than whether it creates a *perception of recovery* that, in turn, becomes a self-sustaining reality by boosting confidence. The improvement seen in a variety of asset markets, as well as nascent gains in various forward-looking consumer confidence measures, suggests this transition may already be underway.

Key Concerns for the US Outlook

Recalling the old axiom that markets climb a wall of worry, perhaps we shouldn't be surprised by the spirited 65% rally we have seen in US equities since their March 2009 lows; after all, there is no shortage of worries regarding the United States. Two concerns in particular, however, have recently become the focus of investor unease: rising public debt and an expectation of runaway inflation. Taken together, these concerns have led many to conclude that the US dollar is doomed and its days as the world's reserve currency are numbered. In the following pages, we examine the legitimacy of these concerns and their implications for the greenback.

Deficits as Far as the Eye Can See

There is no question that fiscal deficits are high, as seen in Exhibit 4. Weak economic growth coupled with a financial crisis has conspired to reduce tax revenues and necessitate a host of fiscal stimulus measures that have increased government spending. As a result, the US fiscal deficit grew to 10.1% of GDP in fiscal 2009, the highest level since World War II and well above the historical average of 3%. Such high deficits, in turn, are compounding an already above-average public debt burden, as a government's debt load is essentially an accumulation of its deficits. For instance, the US public debt rose to 53% of GDP in 2009 from 40% the year before, the result of a 10% fiscal deficit combined with a 3% contraction in GDP. Forecasts have the fiscal deficit as a percentage of GDP slowly falling over the next 10 years but settling above its 3% long-term average. Consequently, US public debt is expected to accrete to over 70% of GDP over the next 10 years (Exhibit 5).

The good news is that deficits tend to be cyclical. A 2008 IMF study found that among the G7 economies, about 60% of the deficit deterioration they expected was due to cyclical factors which would eventually reverse as economic activity normalized. In the case of the US, the decline in tax revenues due to lower household income and corporate profits accounted for approximately two-thirds of the $1 trillion increase the fiscal debt, with the balance accounted for by the government's fiscal stimulus and financial market intervention. Thus, renewed US economic growth will decrease the deficit in two ways: by increasing tax receipts via rising income and corporate profits and by decreasing the need for further fiscal stimulus. This combination is potent, as history shows that for every 1% of nominal GDP growth, tax revenues tend to grow by 2.6% in the following year. Given an upside skew to our GDP growth view, we are comfortable that the cyclical portion of the deficit should improve.

Of course, the growing structural deficits are more troublesome. An aging population and increasing ratio of pensioners to working taxpayers create a major secular tailwind to expanding public debt. In fact, growth in spending on mandatory programs (including Social Security, Medicaid and Medicare) is expected to outgrow GDP by 2.2% on an annualized basis over the next decade. Rising debt service costs just exacerbate the problem. Taken together, estimates have net interest expense and spending on mandatory programs growing to 14.2% of GDP over the next 10 years from just 10.8% currently.

Against the sobering reality of these growing deficits, we find several reasons for optimism. As mentioned, the cyclical nature of deficits suggests that part of the current budget shortfall will naturally correct as economic growth resumes. In addition, budget forecasts are inherently inaccurate. In 2000, the Congressional Budget Office (CBO) projected 10 years of fiscal surpluses, with a surplus of 5.3% in 2009. Instead, what followed was nine years of *deficits*, including a 10.1% deficit in 2009. Furthermore, in 1995 the CBO projected a deficit of 3% for 2000, but what resulted was a *surplus* of 2.4%! Finally, there is scope for a rising tax base. Federal tax revenues stand at the lowest level relative to GDP since 1950. A reversion to more typical postwar levels would equate to several percentage points of deficit reduction. Moreover, the total tax base of the US relative to GDP stands well below the level in any other developed country and the OECD average. Thus, there is capacity for the US to increase taxes without jeopardizing its comparative position in the global economy.

Lastly, it's worth remembering that both personal and corporate tax rates are low by historical standards. While there is raging debate about the impact of such increases on prospective growth, three points bear mentioning. First, higher tax rates have not historically been an impediment to economic growth, as many of the faster-growing periods in American history occurred with tax rates much higher than today's levels. Second, levels matter. If the federal marginal tax rate on the highest income bracket were to revert to its pre-Bush level of 39.5%, it would still stand below the 50% threshold that some experts consider highly detrimental to growth. Third, timing matters. The mistake of both the US as it was exiting the Great Depression and Japan early in their "Lost Decade" was raising tax rates during the nascent phases of economic recovery. Given the approaching mid-term elections, any broad tax hikes are unlikely to come until 2011, a point at which the economy should be on strong enough footing to absorb them. In short, while undoubtedly not welcome news for individual tax payers, the near certainty of tax hikes should benefit deficit levels going forward.

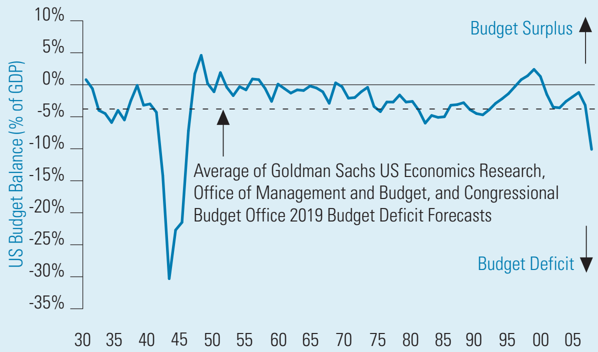
The Inevitability of Runaway Inflation?

Current concerns about inflation generally come in one of two flavors. The first contemplates a scenario where policy makers, lacking the political will to cut entitlement spending and faced with ever-spiraling deficits, let inflation rise as a means of reducing the debt burden (as prices rise, the value of the debt would fall relative to nominal GDP). The second finds its roots in the Weimar Republic of Germany during the early 1920's; namely, that the Fed's rapidly expanding balance sheet will ultimately increase the money supply well beyond the growth of output, causing hyperinflation, which destroys confidence in the dollar itself. While neither scenario is inconceivable, we place low odds on both.

On the first point, we are encouraged by the conclusions of a recent academic paper that examined the relationship between fiscal deficits and inflation in six industrialized nations in the postwar period.[11] The authors concluded that "the relation between fiscal imbalances and inflation suggests extremely modest interactions" because such imbalances are "mainly removed through adjustments in the primary deficit." In other words, governments ultimately took remedial action to close budget gaps before

Exhibit 4: US Budget Balance (% of GDP)

At 10.1% of GDP, the US fiscal deficit is the largest deficit since World War II and stands well above the historical average of 3%.

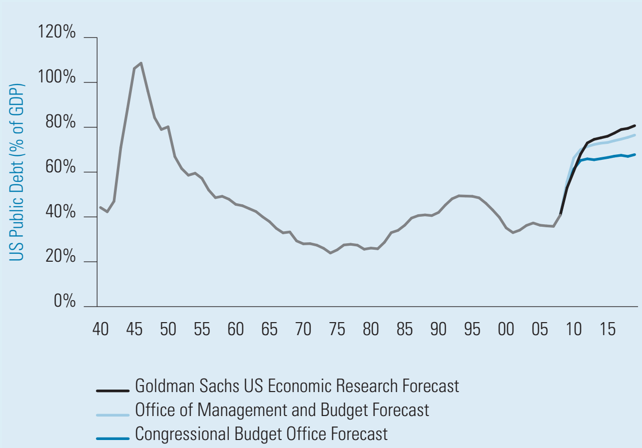


Actual Data Through 2009; Forecast Data as of December 22, 2009

Source: Investment Strategy Group, Goldman Sachs US Economics Research, Congressional Budget Office, Office of Management and Budget

Exhibit 5: US Public Debt (% of GDP)

Continuing budget deficits coupled with spending on mandatory programs is projected to push US public debt well above long-term averages.



Actual Data Through 2009; Forecast Data as of December 22, 2009

Source: Investment Strategy Group, Goldman Sachs US Economics Research, Congressional Budget Office, Office of Management and Budget structural shifts in inflation occurred. For instance, policymakers successfully worked on a bipartisan basis *during* election years to bring about fiscal reform amid the high deficit years of 1984 and 1986. Also, in 1993 when Democrats controlled the House, Senate and White House – similar to today's backdrop – policymakers passed a fiscal reform bill that helped swing the fiscal balance from a deficit of 4.7% in 1992 to a surplus by 1998. Today, growing voter concern about government indebtedness suggests that if current incumbents lack the political willpower to exercise fiscal restraint, their constituents will ultimately elect a replacement who will. Indeed, congressional approval ratings are lower today than when Congress flipped parties in 1994 and 2006. Given the strong self-preservation instincts of elected officials, we suspect remedial action toward the deficits will ultimately be taken.

On the second point, unlike Germany in the 1920s, very little of the rapid growth in the Fed's balance sheet has actually filtered into currency in circulation. In fact, broader monetary aggregates such as M2 have been flat over the last six months. On this point, our colleagues at Goldman Sachs Global Economics, Commodities and Strategy Research concluded that high rates of monetary growth are less likely to result in inflation as long as that growth is not sustained for long periods. Importantly, the vast majority of the Fed's monetary stimulus sits on banks' balance sheets as excess reserves on which they now earn interest. True, these reserves could ultimately find their way into the real economy if banks began aggressively lending. However, given that loan growth typically lags economic recovery by several quarters – not to mention both banks' and households' current desire to deleverage their balance sheets – we find a massive lending binge unlikely.

Of equal importance, the Fed now has many tools at its disposal to withdraw this excess liquidity before it becomes problematic, including paying interest on reserve balances, removing reserves through reverse repos and term deposits, raising short-term interest rates and selling assets in order to shrink the size of its balance sheet. Of course, the Fed could also bring forward the tightening cycle if there were signs that inflation and/or inflation expectations were rising sharply.

In fact, it can be argued that the Federal Reserve has already started tightening by announcing its intentions to end its securities purchase programs (such as mortgage-backed securities and treasuries) and some of the various liquidity facilities it created during the crisis. Moreover, because the Fed charges market participants a premium to access its various liquidity facilities, many, such as the commercial paper facility, have naturally dwindled as their underlying markets normalized. While we acknowledge that the loss of Fed independence through Congressional "audit" schemes could negatively impact inflation expectations, we don't think the risk warrants positioning a portfolio for that outcome.

In considering the credibility of any inflationary scenario above, it is also crucial to acknowledge the large number of *disinflationary* impulses that exist presently. For one, the US economy faces significant economic slack, with some estimating that the output gap (the difference between potential and actual GDP) in the US is as large as 11%. Our view is that real-time estimates of the output gap are difficult to measure and more importantly, they tend to explain only a small portion of subsequent inflation. Even so, other measures of slack lend credence to the disinflationary theme, such as the unemployment rate at close to its 26-year high and capacity utilization near its lowest levels ever. Thus, while there is considerable debate about the correct measure of this slack, each is significantly large enough to corroborate the conclusion.

As a result of this slack in the economy, unit labor costs remain depressed, creating a very different environment than what existed during the inflationary 1970s. Moreover, the disinflationary impulse from globalization remains alive and well and could arguably increase as emerging economies look to sustain their growth through competitively-priced exports. Weighting the above, we expect core inflation to moderate slightly from its current reading to a range of 1.0-1.5% in 2010, with headline inflation of around 1.75-2.25%. Our view reflects the inherent stickiness of core inflation, as well as the fact that inflation expectations remain well anchored.

Implications for the Dollar

Against the above conclusions, we find the reports of the dollar's demise greatly exaggerated. Realistically, there are no alternative currencies that can challenge the reserve currency status of the US in the foreseeable future. At $14 trillion dollars, the US has the largest GDP share in the world, as well as the deepest and broadest capital markets, with US equities accounting for over 40% of global equities and US bonds not far behind at roughly 40% of worldwide debt securities. For comparison, all Euroland equities aggregate to 13.1% of global equities and 28.7% of global debt securities. Of course, US markets are also open and free of capital controls.

The dollar also meets the necessary reserve currency requirements of being freely tradable and convertible, and of belonging to a stable country with a working democracy and an established rule of law. Deep recessions, high inflation and multiple wars have never brought into question the convertibility of the dollar or raised concerns about any form of capital controls. In fact, the recent economic crisis just confirmed the safe haven status of the US dollar: It rose 24.3% on a trade-weighted basis as world markets collapsed from March 2008 to March 2009. Moreover, as highlighted in a March 2008 Harvard Faculty Research Paper there is a strong bias in favor of using whatever currency has been the reserve currency of the past.[12] This "inertial bias," the paper notes, "favors the continued central role of the dollar," particularly against a backdrop where, as of year-end 2008, 64% of total allocated foreign exchange reserves were held in dollars. International trade, furthermore, continues to be invoiced and quoted in dollars.

Notwithstanding these positives, we note that the dollar's currently depressed valuation is a testament to the negative sentiment toward it that prevails in the currency markets. Indeed, the dollar's current valuation is close to its lowest levels since 1973. Importantly, when valuations have reached such levels historically (1979, 1988, 1995 and 2008), the US dollar has generally gone on to appreciate over the subsequent three to five years. As such, our long-term view of the US dollar is generally favorable, particularly relative to currencies of other developed countries.

From a tactical perspective, we currently recommend that clients *increase* their exposure to the US dollar vs. those developed currencies against which it is most undervalued, such as the Japanese yen. In addition to the valuation signal, the yen faces significant uncertainties emanating from Japan's worst-of-breed fiscal position, as well as its growth and deflation outlook. Similarly, while we haven't implemented a specific tactical recommendation at the present time, we also find the dollar attractive relative to the euro, based on both valuation and underlying fundamentals. We discuss these views, as well as our emerging market currency ideas, in more detail later in this report.

Our Viewpoint

In short, we believe a combination of fiscal restraint, economic slack and a viable Fed exit strategy will temper realized inflation, keep inflation expectations anchored and ultimately rein in the primary deficit. Even if deficits were to remain elevated, empirical evidence suggests that the historical link between the US dollar and the fiscal deficit is tenuous at best. As such, we expect neither significant US dollar depreciation nor a change in the status of the US dollar as the world's reserve currency. In fact, given that fiscal deficits are large in most major developed economies, we think that the US dollar could appreciate relative to select currencies in the coming years.

In our view, the issues surrounding the US deficit, inflation and the dollar ultimately reflect concern about the credibility of the US government itself: Will it have the political will to act when necessary? Last year, our view was that the US would successfully navigate the challenges it faced with strong support from various policy actions, no matter how imperfect they may have seemed. Against the myriad concerns discussed above, we continue to take that view.

2010 Global Economic Outlook

Even for the more optimistic among us, it is hard to believe that today we are tasked with charting the shape of the global recovery, when just 12 months earlier our focus was on gauging the potential for a second Great Depression. For the time being, however, it seems the global economy has sidestepped that fate, as leading economic indicators have surged, manufacturing and exports are on the mend and credit markets have improved. In fact, most countries are reporting positive GDP growth again, in many cases at or above trend levels.

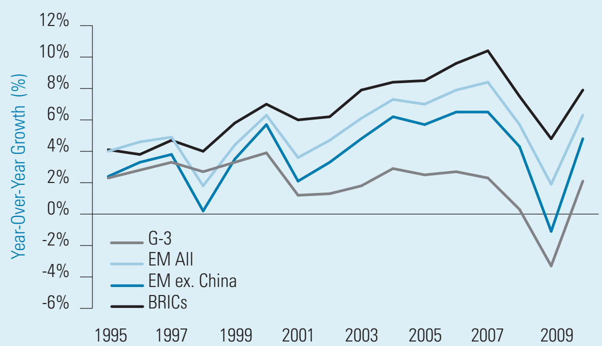
While we are aware of the many potential growth impediments that will ultimately come into focus, such as large budget deficits and the removal of monetary stimulus, we expect the cyclical forces already in motion to sustain growth this year. Our view is predicated on several factors. As already discussed, US growth could surprise to the upside, which would have positive implications for exports globally. Moreover, stronger growth in the US and abroad would mitigate some of the structural pressures facing the developed economies in particular.

Similarly, the highly synchronized, global nature of the downturn should work the same in reverse, to the benefit of global growth. On this point, a recent IMF study found that synchronous global downturns historically have had better growth outcomes than those associated with a financial crisis alone. As seen in Exhibit 6, the current episode certainly qualifies, as emerging economies have been highly correlated with the advanced world during both the collapse and subsequent recovery of economic activity. In addition, the average correlation of quarterly GDP growth among emerging market countries themselves is near 80%, similar to the level among developed economies. Both readings are significantly higher than previous cycles, a testament to the synchronicity of this cycle.

Although the resumption of growth would typically be a harbinger of inflation, the economic slack in many developed nations should temper price increases while also providing cover for accommodative policy and a measured withdrawal of liquidity. As we discuss below, rising inflation could be more of an issue for select emerging markets, given their commodity exposure and fixed exchange rates. Finally, global interest rates are likely to migrate higher over the course of the year, a function of both the low starting level of policy rates globally and an improving growth backdrop. A summary of our GDP, inflation and interest rate forecasts for the developed economies is presented in Exhibit 7.

Exhibit 6: Highly Synchronized Global Growth

Emerging economies have been highly correlated with the developed world during both the collapse and subsequent recovery of economic activity.



Data as of December 31, 2009; ISG forecasts through 2010

Source: Investment Strategy Group, Goldman Sachs Global Investment Research

Euroland

After a staggering 5.1% peak-to-trough decline in Euroland GDP, we expect a return to moderate growth in 2010. Just as the credit crisis hurt both European exports and investment, which together accounted for over 80% of the economic contraction, the moderation of these headwinds should help growth this year. Even so, although exports should benefit from a revival of world demand and a firming of trade financing, investment is likely to remain sluggish given low capacity utilization and still-spotty bank financing. Furthermore, as in the US, government spending is likely to wane in the back half of the year, only partially offset by mild consumption growth. As such, we expect GDP growth of 1.25-1.75% and mild inflation.

With Euroland GDP returning to positive growth, the ECB might start withdrawing liquidity in the first half of the year and raising its policy rate later in the year. These policy actions, coupled with still-high fiscal deficits, will likely pressure long term rates higher. Overall, we expect Euroland 10-year rates to rise to 3.75% to 4.25%, with spreads widening further within the zone.

We expect the euro to depreciate. Several factors are likely to weigh on the euro, leading to its depreciation over the medium term. For one, valuations are unattractive, as the euro is about 20% overvalued relative to the dollar and 10-15% relative to the British pound. Second, the resumption of US growth this year should temper concerns about the dollar's reserve status, diminishing the euro's appeal as an alternative. Meanwhile, the ongoing negative toll of a strong euro on the region's exports makes a weaker currency politically desirable, with rising default risks in troubled euro economies like Greece serving as the impetus for action. Taken together, these factors bias us toward being short the euro, subject to a catalyst. In our view, that catalyst will be the willingness of emerging market countries, especially in Asia, to appreciate their currencies against the dollar, as this will remove an important source of support from the euro.

United Kingdom

The resumption of economic growth in Euroland, the UK's main trading partner, should help bolster the export tailwind that already exists from the country's weak currency. At roughly 20% of GDP, exports have a material impact on UK growth. That said, high debt levels, persistent unemployment and low savings rates will likely temper consumption growth. Furthermore, low capacity utilization will pressure capital investment. Weighing these factors, our expectation is for moderate growth of around 1.5% to 2.0% this year.

Unlike many other developed nations, where output slack is suppressing price increases,

Exhibit 7: ISG Economic Outlook Scenarios for Developed Markets

Across the developed markets, we expect moderate growth, relatively tame inflation, still-accommodative monetary policy and normalization in 10-year rates.

	United States		United Kingdom		Euroland		Japan	
	Current	2010 Forecast	Current	2010 Forecast	Current	2010 Forecast	Current	2010 Forecast
Real GDP*	-2.5%	2.5 – 3.0%	-4.5%	1.50 – 2.00%	-3.8%	1.25 – 1.75%	-5.4%	1.25 – 1.75%
Headline CPI**	1.9%	1.75 – 2.25%	1.9%	2.25 – 2.75%	0.9%	1 – 1.5%	-1.9%	(0.75) – (1.25)%
10-Year Rate	3.84%	4.25 – 4.75%	4.01%	4.5 – 5.0%	3.39%	3.75 – 4.25%	1.29%	1.25 – 1.75%
Policy Rate	0 – 0.25%	0.25 – 0.50%	0.50%	0.5 – 1.0%	1.00%	1 – 1.25%	0.10%	0.10%

Data as of December 31, 2009

* Real GDP levels are consensus estimates for 2009 real GDP growth.
** For current headline CPI readings we show the year-over-year inflation rate for the most recent month available.
Source: Investment Strategy Group, Bloomberg

inflation has proven resilient in the UK. For example, reported inflation has been stronger than the Bloomberg consensus 12 out of the last 15 months. Looking forward, both the weak pound and the reversal of the temporary Value Added Tax (VAT) hiatus will add to these inflationary pressures. The implication is that such persistent inflation, further stoked by the resumption of economic growth, could lead the Bank of England to tighten early, particularly given its strict inflation targets.

As such, we expect long term rates to move higher. While expanded quantitative easing presents a risk to this view, we suspect the BOE's inflation mandate and burgeoning deficits will push long rates to 4.5-5% by the end of the year.

The pound sterling is likely to remain range-bound against the dollar and to appreciate moderately against the euro. The pound has been among the weakest developed market currencies, falling 25% on a trade weighted basis over the last two years. Given this underperformance, it now screens as about 10-15% undervalued against the euro, although only fairly valued relative to the dollar. Consequently, we expect the pound to slowly appreciate against the euro as concerns over the UK economy dissipate. Because we also anticipate the dollar strengthening against the euro, the pound is likely to remain range bound relative to the dollar as a result. The upcoming elections and resulting uncertainty about fiscal reforms represent a clear risk to this view.

Japan

The Japanese economy was one of the primary casualties of the global slowdown, as GDP contracted 8.6% peak to trough during the crisis as exports collapsed. The government's apparent apathy toward the strengthening yen only exacerbated the decline, while the breakdown in output rekindled deflationary forces. In turn, the stronger yen and rise in real rates due to deflation dramatically tightened financial conditions, further undermining economic growth.

In considering the likely path of Japan's recovery, the lynchpin is ultimately the government's policy response and its eventual impact on the yen. If the Bank of Japan (BOJ) succeeds in weakening the yen through quantitative easing, that would provide a clear tailwind to export growth, the principle driver of Japan's economy. Furthermore, the Democratic Party of Japan's recent fiscal stimulus should help consumption growth, although it is unclear how much is likely to be saved vs. spent.

Against this uncertain policy backdrop, we expect the Japanese economy to expand 1.25% to 1.75%, an admittedly tepid growth forecast given the magnitude of the contraction. Part of this guarded outlook reflects the myriad structural headwinds that Japan faces, including its large budget deficits, falling savings rates and shrinking workforce. Of equal importance, political uncertainty remains high, particularly with the July election of the House of Councilors. Such uncertainty is likely to weigh on investment and consumer confidence.

Given relatively slow growth and persistent deflationary pressures, we expect that the Bank of Japan will keep its policy rate near zero throughout 2010. In addition, it is likely to target tight financial conditions through some combination of committing to low rates for an extended time period and further quantitative easing. As such, despite large fiscal deficits that will pressure rates higher, we expect countervailing policy initiatives to keep 10-year yields in the 1.25-1.75% range.

In our view, the yen will depreciate over the medium term. Based on several measures, the yen is substantially overvalued, especially against the US dollar. In addition, the persistence of sluggish growth and deflation suggests the BOJ is likely to tighten much later than other central banks. The resulting interest rate differential will likely weigh on the yen. Moreover, large budget deficits coupled with a falling household savings rate will put downward pressure on the country's current account, weakening a force that has traditionally supported the yen. Accordingly, we recommend clients remain short the yen against currencies associated with improving economic fundamentals, namely the US dollar, Swedish krona and Australian dollar.

Exhibit 8: ISG Economic Outlook Scenarios for Emerging Markets

With the exception of China, we expect higher growth and high inflation in the BRICs.

	China		Brazil		India		Russia	
	Current	2010 Forecast	Current	2010 Forecast	Current	2010 Forecast	Current	2010 Forecast
Real GDP*	8.2%	8.5 – 10.5%	0%	5.0 – 6.5%	5.5%	7.0 – 8.5%	-7%	3.0 – 5.0%
Headline CPI**	0.6%	2.0 – 3.5%	4.2%	4.0 – 5.0%	4.8%	5.0 – 6.5%	8.8%	6.0 – 9.0%

Data as of December 31, 2009

*"Current" real GDP levels are consensus estimates for 2009 real GDP growth.
**For current headline CPI readings we show the year-over-year inflation rate for the most recent month available. WPI is shown for India.
Source: Investment Strategy Group, Bloomberg

Emerging Markets

Against the backdrop of global economic recovery, we expect emerging market growth to rebound to almost trend levels this year. A combination of improved trade, renewed access to credit and the impact of aggressive policy responses will underpin this growth. Far from being de-coupled, emerging market economies stand as prime beneficiaries of stronger developed world growth, particularly in the US. That said, with many emerging countries using fiscal and monetary stimulus for the first time during the crisis, this renewal of growth could quickly make their policy settings too accommodative. The resulting interactions between growth, policy and inflation will have important implications for emerging market currencies, many of which we expect to experience appreciation pressures. A summary of our GDP and inflation forecasts for the emerging markets is presented in Exhibit 8.

Emerging Asia

Dominated by two of the largest and fastest-growing emerging markets, China and India, Asian growth should outperform in 2010. Even excluding these giants, we expect growth in the Asian economies to rebound to pre-crisis levels of around 5% as global conditions stabilize. While the rise in intra-Asian trade will contribute to this growth, the region remains heavily dependent on final demand outside of Asia. As such, until the region's policy makers are confident about the sustainability of the US recovery, they will likely lean against significant currency appreciation to protect their exporters.

China China's massive two-year stimulus program should ensure robust growth of about 8.5-10.5% in 2010. While government-influenced demand accounts for half of the projected expansion, residential investment and consumption should also contribute. Both will be aided by China's very loose monetary policy, which includes a 30% expansion in lending that should extend into this year. The inflationary impact of China's expanding money supply will likely be tempered by monetary tightening and the deflationary impact of the "excess capacity" of large state enterprises. Our resulting base case is a moderate increase in inflation of roughly 2-3.5% this year.

India Indian growth should accelerate by an impressive 7-8.5% in 2010. Although its capacity for fiscal and monetary stimulus lagged that of China, India's large and relatively closed economy partially insulated it from the global crisis. Indeed, India's domestic demand kept growth above 6% in 2009. With such persistent growth, India's output gap is expected to close much faster than the advanced economies. As such, we expect elevated inflation of 5-6.5% in 2010 to force the central bank to meaningfully tighten monetary policy.

Asian Area Currencies Select Asian currencies should provide attractive risk-adjusted returns in 2010. More specifically, we favor the currencies of India and Indonesia as both weakened significantly during the crisis. In addition, both rely more heavily on domestic demand than exports, a characteristic which not only buffered them during the crisis but should also allow them to be among the first to raise rates or allow appreciation in 2010. As the US recovery takes hold, we expect opportunities to emerge in other Asian currencies whose central banks have thus far resisted capital inflows so as to allow only moderate strengthening of their currencies. This theme will come increasingly into focus if, as we expect, China decides to resume the renminbi's appreciation later in the year.

Emerging Europe

Emerging Europe (including Central and Eastern Europe (CEE) countries, Russia, Turkey and South Africa) was the developing region hit the hardest during the recent global financial crisis. Underlying this weakness was the region's reliance on external financing to support its rapid expansion and its recent integration into the EU, both of which made it particularly vulnerable to the cessation of global capital flows. Indeed, the downturn could have been even worse were it not for the IMF's overall quadrupling of its lendable funds. On the back of this support and the broader global recovery, region-wide growth should rebound to almost 4% in 2010, slightly below its pre-crisis trend. That said, risks remain elevated for the peripheral countries such as the Ukraine, Romania and the Baltics.

Russia Even the combination of a $600 billion war chest of reserves and virtually no sovereign external debt could not insulate the Russian economy from the perfect storm of collapsing oil prices, the invasion of Georgia and the termination of external financing during the crisis. The subsequent rebound in oil prices and the government's rapid injection of fiscal and monetary stimulus – thanks to its sizable oil stabilization fund – should allow the country to recover from one of the deepest recessions in the world and grow 3-5% in 2010. Nevertheless, progress remains fragile, and the direction of oil prices and pace of credit growth will be key indicators to monitor in gauging the sustainability of the recovery.

Emerging European Currencies Emerging Europe's relatively loose monetary policy and reliance on growth in Europe make it a less attractive region for meaningful currency appreciation vs. the euro in 2010. Our focus will be on currencies that have underperformed but whose underlying economies expect to see strong growth in the year ahead, such as the Polish zloty.

Latin America

The global crisis has had a more selective impact on Latin America than elsewhere. While Mexico registered a severe recession of about -7% in 2009 due to its reliance on the US economy, Chile emerged relatively unscathed, experiencing a shallow recession and now a robust 2010 outlook. The delineating characteristic seems to be how much economic prudence a country exercised in the past decade. For example, Chile, which had saved most of its "excess" copper export revenue, fared infinitely better than fellow commodity exporters Argentina and Venezuela, which had spent most of their resource windfalls.

Brazil As the region's largest economy, Brazil falls in the former category. A combination of resilient domestic demand and loose policy should drive strong growth of 5%-6.5% in 2010. That said, this growth comes with correspondingly high inflation risks. Particularly in an election year, Brazil's pro-growth stance may unhinge inflationary expectations and lead to price pressures.

Latin Currencies The direction and pace of currency movements in Latin America should broadly follow the path of commodity prices, which we anticipate to be range-bound. Among the major regional currencies, our focus will be on whether faster-than-expected US growth translates into outperformance of the Mexican peso vs. the region. As for the Brazilian real, we see the positive drivers balanced against a host of negatives, including a widening current account deficit, election year volatility, increased use of currency intervention and capital controls, as well as the most expensive valuation in emerging markets.

2010 Financial Markets Outlook

It may sound surprising, but in many ways the equity landscape of 2010 is much murkier than that of last year. In 2009, the investment thesis rested on the notion that the world was not destined for another Great Depression. If that supposition proved correct, assets priced for such an outcome would offer very attractive returns as they began to discount more normal fundamentals. In essence, depressed valuation multiples at the time provided an attractive margin of safety for investors, even against a backdrop of highly uncertain political, economic and corporate fundamentals. A summary of 2009 returns by major asset class is presented in Exhibit 9.

With those valuation dislocations largely in the rearview mirror, investment success will require an increasingly nuanced read of market variables. While there are dominant idiosyncratic factors in each market, we noticed several recurring themes that transverse them. Taken together, these themes should reward fundamental analysis and active management this year:

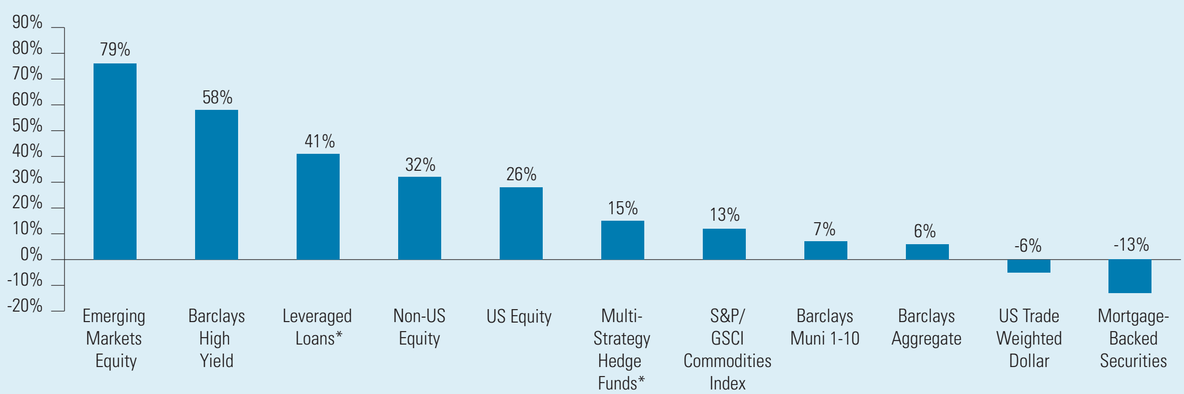
The Ascendancy of Earnings

With valuation multiples largely back to long-term average levels, the focus will shift toward earnings growth to drive the next stage of market appreciation. Historically, this phase favors lower beta, large-capitalization growth companies (e.g., many modern-day technology stocks).

Operating Leverage

Corporations reacted to the global downturn aggressively, cutting fixed costs and lowering capital expenditures. The result is that small increases in revenue now generate disproportionately sized earnings growth. As such, even tepid GDP growth could still foster meaningful profit growth.

Exhibit 9: 2009 Asset Class Performance



Data as of December 31, 2009, except where indicated

* Performance through November 2009.

Source: Investment Strategy Group, Datastream, Barclays Capital, Credit Suisse, Markit, Bloomberg

Falling Correlations

Much to the chagrin of decoupling proponents, correlations between the major developed and emerging markets remain historically high. In fact, as shown in Exhibit 10, Euroland and emerging market correlations to the US are 93% and 87%, respectively, among the highest readings on record. Moreover, the average sector correlation for the 10 S&P 500 sectors is nearly 80%. Because correlations tend to be mean-reverting and generally fall as economic stress abates, we expect falling correlations to provide a more target-rich environment for relative value and cross-sector trades this year.

Merger & Acquisition Rebound

With global corporations cash rich and in search of ways to bolster organic growth, increased merger and acquisition activity is likely, particularly with many firms still trading below private market value. Indeed, we have already started to see M&A activity increase in the technology and consumer product sectors.

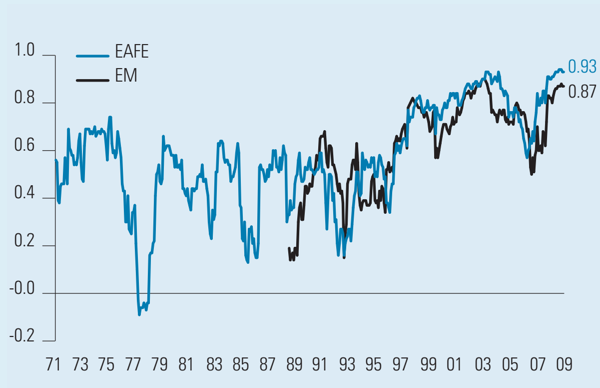
Contrary Sentiment

It pays to track retail investment flow, as recent academic work has demonstrated empirically that flows have a *negative* correlation with subsequent returns. In 2009, retail investors overwhelmingly favored bonds over stocks, and within equities, international over the US. In turn, emerging markets, and the BRICs (Brazil, Russia, India and China) in particular, have seen the lion's share of international flows.

As is typical in market recoveries, a good portion of the expected three-to-five-year annual returns implied at the March trough were pulled forward in 2009 as prices rallied. Exhibit 11 highlights how as US prices rallied, expected returns have fallen. Thus, while the pure directional bet on the market has likely come and gone, equities broadly still seem priced for reasonable returns, particularly relative to bonds.

Exhibit 10: Correlations to US Equities (Rolling 24 Month)

No sign of decoupling, as correlations between US equities and both developed and emerging market equities stand near all-time highs.

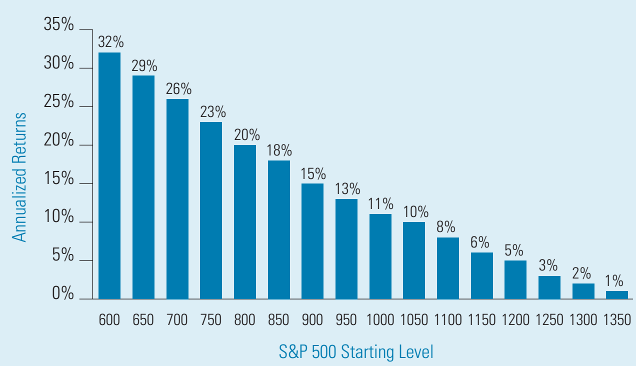


Data as of December 30, 2009

Source: Investment Strategy Group, Datastream

Exhibit 11: Implied US Equity Returns Fall as Prices Rally

Starting valuations matter, as a return to trend earnings and a trend multiple from today's S&P 500 level implies about 7% annual gains vs. the roughly 30% implied at the March 2009 low.



Data as of December 31, 2009

Source: Investment Strategy Group

US Equities: The Disdained Rally

Perhaps it's not surprising that investors have greeted the 2009 US equity rally with more than a dose of skepticism, if not outright disdain, considering it followed the *second* equity market decline of greater than 50% in the last decade. Indeed, among the most striking features of this rally, at least as far as the US market is concerned, has been the lack of retail participation. Of course, sentiment and positioning is just one aspect of our market view. In our work, four factors determine our market outlook:

Valuations As can be seen in Exhibit 12, today's valuation measures reside around the middle of their historical postwar ranges, suggesting much of the multiple compression seen at the March 2009 lows has been normalized. Importantly, fairly valued does not mean over-valued. Instead, with valuations near fair levels, the market's focus will increasingly shift toward corporate fundamentals.

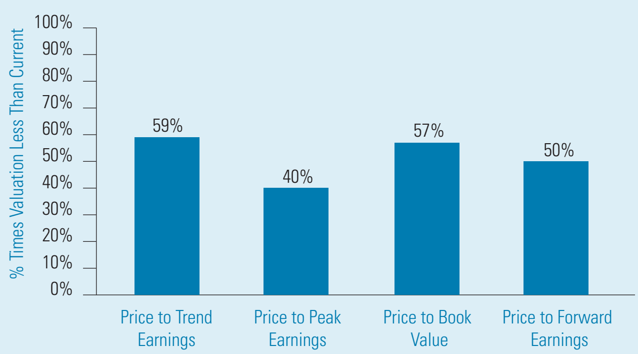
Fundamentals In considering the path of corporate earnings, it's worth noting that Standard & Poor's reported earnings fell a staggering 92% in this cycle, greater than the 75% decline seen during the Great Depression. Similarly, even operating earnings, which ostensibly exclude all non-recurring expenses, declined 57%, the worst decline in the postwar period. As such, the progression of current earnings back toward trend levels represents a sizable tailwind for earnings growth.

This is not simply a blind mean-reversion argument, however, as there are several fundamental underpinnings. For one, the scope and pace of management cost cutting has been dramatic, with Selling, General and Administrative costs (SGA) falling at a 9% yearly rate in the third quarter. Of equal importance, the truly aggressive cuts were made in the most cyclically exposed sectors, suggesting the entire earnings base today is more levered to economic recovery than in previous cycles. Secondly, while mark-to-market accounting may have exacerbated the earnings collapse, it also hastened the inevitable loss-recognition process. With roughly two-thirds of estimated full-cycle credit losses already recognized, earnings should benefit meaningfully as this drag abates. Lastly, low corporate borrowing costs and a steep yield curve are providing a tailwind to earnings recovery.

The resulting operating leverage is already evident in net margin resilience. Unlike previous recessions which invariably saw net margins (excluding financials) trough between 4-5%, the current episode bottomed at roughly 6% and has already recovered to an estimated 6.8% for 2009. What was made clear in this downturn is that corporate America has benefitted tremendously from globalization. By outsourcing lower value-added activities, US firms have lowered capital intensity and increased labor productivity, both of which bolster cash flow and increase margins. That margins held up this well during the worst economic and financial crisis in the postwar period highlights the structural nature of the improvement. The upshot is that while many are concerned about tepid economic growth being a drag on profitability, US GDP of 2-4% would likely be sufficient to crystallize this latent operating leverage. As such, we expect reported earnings to come very close to recapturing trend levels in 2010.

Exhibit 12: US Equity Valuations Metrics

Current valuations for the US equity market appear neutral relative to their historical levels.



Data as of December 16, 2009

Source: Investment Strategy Group, Standard and Poor's, Robert Shiller

Technicals The technical backdrop remains favorable, in our view. For one, the S&P 500 remains in an uptrend, demonstrated by a series of higher lows in price and continued trade above the key 50- and 200-day moving averages. Secondly, there is precedence for the current resistance at 1,121, the 50% retracement level of the entire S&P 500 decline, to ultimately lead to higher prices. In both the 1990 and 2002 recovery analogues, the market initially struggled to surpass the 50% retracement level but ultimately moved higher after a period of consolidation. In addition, the S&P 500 registered a monthly MACD (a momentum-based technical indicator) buy signal with its monthly close of 1,020 in August of 2009. In the postwar period, this indicator has never generated a false buy signal from such oversold levels. The average maximum gain within 12 months of the historical buy signals was 17%, implying an S&P target of around 1,200. Lastly, excluding the current episode, there have been 16 distinct 10-year periods since 1871 where real equity returns were negative. Importantly, the average annual real return for the *subsequent* decade was around 11%, with a maximum of 17% and a minimum of 6.2%. In short, the mean-reverting tendency of equity returns suggests the next decade of returns should be materially better than the preceding one.

While many have highlighted the low volume of the rally as evidence of technical weakness, we think this could be evidence of retail investors' overwhelming preference for bonds vs. stocks in this cycle, a potential contrarian positive for equities which we discuss in greater depth below.

Sentiment/Positioning Among the most striking features of this rally, at least as far as the US market is concerned, has been the lack of retail participation. Despite the market being up 26% in 2009, US equity mutual funds and non-commodity exchange traded funds saw outflows of roughly $42 billion. Moreover, global outflows were roughly double this amount at $85 billion according to EPFR Global. Instead of stocks, retail investors poured their money into bond funds and fixed income ETFs, which saw inflows of about $268 billion. Interestingly, this trend persisted throughout last year. Whereas only 40% of the weeks in 2009 saw positive equity inflows, 94% had positive bond flows. In fact, the Pimco Total Return Fund, run by Bill Gross, is set to become the largest mutual fund in the industry's history with over $200 billion in assets.

Thus, at a time when the free cash flow yield of stocks is near parity with Baa yields (a beneficial stock condition that has existed less than 2% of the time since 1970), household bond holdings stand at all-time highs, representing around 21% of total discretionary financial assets (a level exceeded only 3% of the time since 1970). Tellingly, a recent academic paper determined that it's not wise to follow the crowd when it comes to mutual fund flows, highlighting "significant negative correlation between sentiment-driven fund inflows and future returns."[13] Indeed, even moderate rebalancing toward stocks by retail investors, who represent 85% of mutual fund owners, would represent a sizable tailwind to equities this year.

Our View on the US Market

Whereas we had expressed a bias toward simply owning the S&P 500 last year given broadly compressed valuations, we suspect a more differentiated, sector-specific approach will be better rewarded this year. As such, we continue to like technology, which benefits from high operating leverage, global exposure and still-attractive relative free-cash-flow yields. Despite being the strongest performing sector in 2009, we think investors continue to underestimate the durability of free-cash-flow margins in this cycle. We also still favor exposure to the homebuilding sector. Here, normalized valuations remain attractive, fundamentals have stabilized and several firms could return to profitability after several years of losses. Lastly, the telecommunication sector is an area we are investigating, as valuations look reasonable, dividend yields are attractive, and already attractive free-cash-flow yields are set to expand given anticipated capital spending cuts in 2010. This sector also stands to benefit from telecom-related stimulus spending which will begin in earnest this year.

Exhibit 13: ISG US Equity Scenarios – Year-End 2010

In our central case, the S&P 500 will reach a price range of 1150 to 1225 by year's end.

	Good Case (25%)	Central Case (60%)	Bad Case (15%)
End 2010 S&P 500 Earnings	Op. Earnings $85 Rep. Earnings $75 Trend Rep. Earnings $69	Op. Earnings $70–75 Rep. Earnings $60–64 Trend Rep. Earnings $69	Op. Earnings ≤ $55 Rep. Earnings ≤ $45 Trend Rep. Earnings $69
S&P 500 Price-to-Trend Reported Earnings	18.5–20.0x	15.5–18.5x	10–11x
End 2010 S&P 500 Fundamental Valuation Range	1277–1380	1070–1277	690–760
End 2010 S&P 500 Price Target (based on a combination of trend and forward earnings estimates)	1330	1150–1225	760

Data as of December 22, 2009

Source: Investment Strategy Group

Overall, the market is now priced to deliver average annual returns of about 7% per year. While this return remains attractive relative to risk-free assets, it is roughly in line with long-run historical equity returns. As such, while the market dislocation that warranted our tactical overweight to the S&P 500 has normalized, we continue to recommend clients build toward (or maintain) their strategic allocation to equities. Our US equity scenarios for this year are presented in Exhibit 13.

Euroland and the UK

While most global equity markets have seen their valuations revert to trend levels or better, Euroland multiples have lagged. This is largely a reflection of lingering concerns about financial-sector exposure and the ongoing difficulty of coordinating policy for multiple member countries with varying degrees of economic health. Indeed, the rising default risks of peripheral Eurozone economies like Greece and Spain, exacerbated by the persistent strength of the euro, have crystallized these concerns.

With these issues arguably reflected in current valuation discounts, the risk/reward to Euroland equities looks interesting. Aside from valuations which remain below average on an absolute basis and neutral to cheap relative to the US, Eurozone equities have a high beta to global growth, given that exports account for about a quarter of the area's GDP. As such, any upside surprises in US or emerging market growth should translate to better equity returns for Eurozone stocks. By the same token, any weakening of the already overvalued euro would augment this export-led recovery.

In addition, earnings stand about 15-30% below trend, providing some fuel for mean reversion. The transition should be aided by the current operating leverage of Eurozone companies, whose profits should therefore benefit from an uptick in global growth. This earnings tailwind is complimented by the potential for positive investment flows, as both retail and institutional investors' equity allocations stand below historical averages. Technicals also look supportive: Euroland equities remain about 40% below their peak, which translates to 15-20% upside if they were rebound as much as other developed markets.

While the UK market also benefits from global growth and screens attractively on absolute valuation measures, it is neutral to slightly expensive relative to the US. Moreover, its larger financial-sector weighting magnifies the risks of de-leveraging, regulation and dilution. Although the aggressiveness of fiscal and monetary stimulus is creating a favorable liquidity backdrop, it seems analyst earnings expectations are already high and positive revision momentum has stalled. With the compelling valuations and currency tailwind that led us to overweight the UK market having diminished, we now find Euroland equities more appealing. A list of global equity market valuations is presented in Exhibit 14.

Japan

In theory, Japan should be the ideal beneficiary of a global recovery, as more than half the country's expected profit growth is export driven. Because of this export focus, however, profit growth is highly sensitive to yen fluctuations, with the unchecked strength of the currency this year suffocating any export improvement. As a result, financial conditions have actually tightened significantly in Japan over the last six months. Even so, both monetary and fiscal policy responses have, until recently, been unsympathetic toward either the yen strength or the resulting economic weakness. Not surprisingly, Japanese equities have underperformed all major equity markets, up just 6% in 2009.

Despite this underperformance, valuations relative to both US and EAFE ex-Japan are neutral, although absolute valuations appear attractive and earnings stand well below historical averages. However, the relevance of such averages in a market that remains in secular decline is difficult to gauge. Moreover, a resurgence of equity supply this year, resulting from continued issuance by ostensibly cash-rich Japanese firms and a number of accounting and regulatory changes which will unwind cross-shareholdings, provides a further headwind.

Against this backdrop, policy decisions will likely dictate equity performance. If the Democratic Party of Japan supplements recent fiscal stimulus with structural reforms and the Bank of Japan succeeds in weakening the yen through quantitative easing, sentiment is sufficiently negative that Japanese equities could easily rally in the double digits. In the absence of a policy trigger, however, Japanese equities are likely to languish, generating mid-single-digit returns. Given the spotty track record of Japanese policy actions, we find the risk/reward more compelling in other developed markets.

Exhibit 14: Global Equity Market Valuations

	Price to Book		Price to Forward Earnings	
	Current Value	Historical Average	Current Value	Historical Average
US	2.2	2.4	14.8	15.6
Japan	1.2	2.3	20.2	33.1
UK	2.0	1.9	13.6	14.1
Germany	1.4	1.9	14.0	16.7
France	1.4	1.7	13.6	15.0
Italy	1.0	1.7	13.1	15.7
Emerging Markets	2.3	2.1	14.7	12.3
Brazil	2.3	1.8	13.6	11.0
Russia	1.2	1.6	9.0	8.2
India	3.7	3.1	17.4	14.1
China	2.7	2.4	15.6	13.6

As of Mid-December 2009

Source: Investment Strategy Group, MSCI, IBES

Emerging Markets

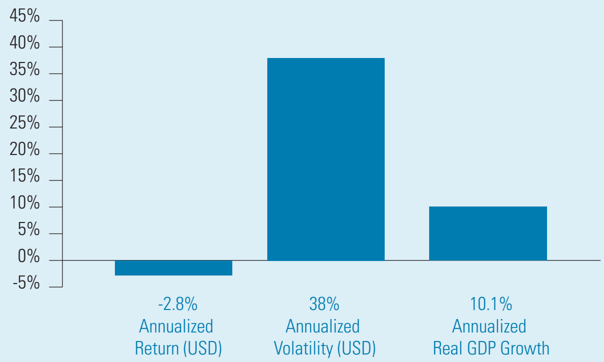
There is no question that emerging market equities have rallied sharply from their lows, as the MSCI EM index is up some 110%, compared with about 65% for the US market and 70% for EAFE. While positive investor sentiment and higher market betas have contributed to these returns, base effects have also played an important role, as many of these markets suffered dramatic equity price declines before recovering. For example, although China has increased an extraordinary 132% from its trough, that advance was preceded by a staggering 74% decline.

In considering the attractiveness of emerging market equities, several factors stand out. The first is the importance of differentiating between economic growth and equity performance. While it's true that many emerging markets have strong underlying growth, there has not been a consistent historical relationship between such growth and forward equity returns. For instance, as shown in Exhibit 15, while China has averaged around 10% annualized GDP growth since 1993, real equity returns over the same period have been slightly negative and accompanied by significantly higher volatility along the way. Part of this disconnect can be traced to strong growth resulting in higher expectations, often setting the stage for disappointment. Consider that consensus already expects 16% long-term earnings growth for emerging markets broadly, which is not a trivial hurdle. Moreover, long-term structural growth trends are frequently dwarfed by cyclical factors over a typical investment horizon. For instance, stronger growth in many emerging markets today is fueling inflationary concerns, with the resulting pressure for policy tightening a clear headwind for valuation multiples. In contrast, the relatively slower growth in many developed markets is providing cover for accommodative policy, a tailwind for multiples.

Instead of growth, starting valuation levels are a more important driver of expected returns, as investors have to consider what they are *paying* for growth. On this point, current overall emerging market valuation levels seem unattractive, whether viewed on an absolute

Exhibit 15: Higher Growth Does Not Always Equate to Higher Returns

While China averaged around 10% annualized GDP growth since 1993, equity returns over the same period have been slightly negative and accompanied by significantly higher volatility.

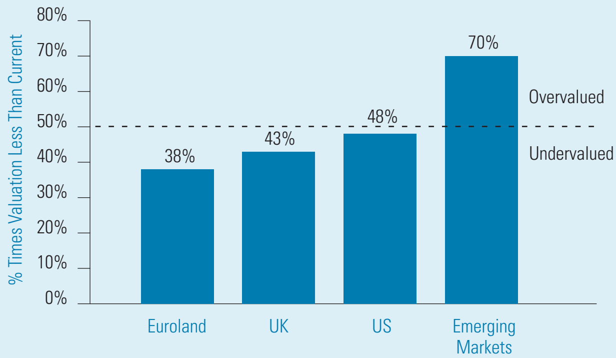


Data as of December 31, 2009

Source: Datastream, Barclays Capital, Investment Strategy Group

Exhibit 16: Emerging Markets Appear Overvalued

On average, emerging market equity valuations[1] appear to be relatively high while most major developed markets appear to be neutral to slightly cheap.



As of mid-December 2009

[1]Average of Price to Trend Earnings, Price to Forward Earnings, Price to 10-Yr Cash Flow and Price to Book

Source: Investment Strategy Group, MSCI, IBES or relative basis (as shown in Exhibit 16). To wit, emerging market equities currently trade at a *premium* of 5% to the US and 29% to EAFE on a price-to-cash flow basis, compared with its historic *discount* of around 10% to both. Similarly, narrowing the analysis to the last 10 years only heightens the divergence, as the discount over that period has been 22% and 19% compared with US and EAFE, respectively.

In addition to valuation, it is also important for investors to consider the amount of risk they are taking in search of higher emerging market returns. As shown in Exhibit 17, which presents our global equity target ranges, while the implied upside may be more attractive in emerging markets, those returns come with much higher risk. Thus, investors' expected return per unit of risk, with risk defined as the underlying volatility of returns, appears less attractive for emerging markets than it does for many developed markets.

In short, while we acknowledge that emerging market outperformance could continue on the back of positive investment flows and US growth surprising to the upside, our tactical enthusiasm is tempered by valuation and sentiment concerns. On the latter point, we are struck by the overwhelmingly positive investor sentiment toward emerging markets, typically a contrary indicator. For instance, the MSCI Emerging Market ETF (ticker EEM), is now the third largest ETF with $37 billion in net assets. Similarly, US investors have moved roughly $34 billion into emerging market mutual funds and ETFs this year. In our view, an investor can get cheaper, more transparent and less volatile access to underlying emerging market growth by owning fairly valued multinationals. These firms actually sell to emerging market regions, as opposed to the local indices which capture the profits of emerging market companies that predominantly export to developed nations.

BRICs

While we remain broadly neutral emerging market equities, Russia stands out as an interesting opportunity in our work. Valuations appear attractive on an absolute basis and not prohibitive on a relative one, screening as neutral compared to the developed world. Moreover, earnings stand about 40% below trend level, affording potential for mean reversion. While analysts expect relatively robust earnings growth of 28% this year, this largely reflects a low starting base, as Russian earnings were particularly hard hit in the crisis. Indeed, even if this growth comes to fruition, earnings would still stand 26% below trend. Lastly, Russia could be an interesting way for investors to express a bullish oil view, as 57% of the MSCI Russia Index is concentrated in the energy sector.

Turning to the other BRICs, China, Brazil and India all screen as expensive in our work, on both an absolute and relative valuation

Exhibit 17: ISG Global Equity Scenarios – Year-End 2010

While the implied upside may be more attractive in emerging markets than say the US, those returns come with much higher risk.

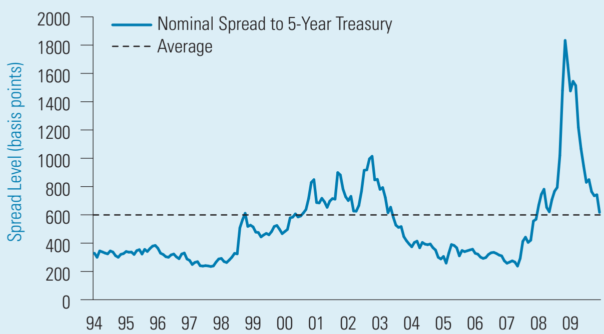
Country	Reference Index	Current Level	2010 Target Range		Implied Upside		Volatility Since 1988
US	S&P 500	1115	1150	1225	3.1%	9.9%	15%
Eurozone	MSCI Euro	879	950	1025	8.1%	16.6%	18%
UK	MSCI UK	1608	1650	1725	2.6%	7.3%	15%
Japan	MSCI Japan	569	600	675	5.4%	18.6%	20%
Emerging Markets	MSCI Emerging Markets	43,130	41,450	49,730	-3.9%	15.3%	24%

As of December 31, 2009

Source: Investment Strategy Group, Datastream basis. While there is precedence for higher multiples historically, these periods have typically represented the peak of valuation spikes. As such, these rich multiples have occurred infrequently in the past. More encouragingly, earnings have scope to appreciate toward trend levels for each of the three countries, given the downdraft last year. That said, consensus expectations already imply a return to trend or better this year. While this is not an insurmountable hurdle, it does raise the risk of disappointment. Among these three, Brazil stands out as the least attractive, having the highest valuation, most aggressive earnings expectations, and heaviest dependence on commodities.

Exhibit 18: US Corporate High Yield Spreads

High yield spreads have quickly collapsed to long-term average levels.



Data as of December 31, 2009

Source: Datastream, Barclays Capital, Investment Strategy Group

High Yield Update

As we highlighted in our March 2009 publication *Give Credit Its Due*, the perfect storm of collapsing corporate fundamentals and forced institutional selling positioned corporate credit to deliver extremely attractive risk-adjusted returns, particularly in high yield bonds. But even for the bullish among us, the speed and magnitude of the ensuing credit market recovery has been astounding, as shown in Exhibit 18. The resulting total returns have been equally impressive, with the high yield bond market returning close to 60% in 2009, its highest return on record.

With high yield spreads now rapidly approaching their long-term average levels, however, it is unlikely that last year's stunning performance will be duplicated in 2010. That said, we retain a 2% overweight to high yield bonds based on several investment positives. For one, the negligible returns on cash and low treasury yields, which have compelled investors to search elsewhere for yield, will likely continue in 2010, a positive tailwind for risk assets like high yield bonds. In addition, the likelihood of defaults by high yield companies has been meaningfully lowered over the course of 2009 in two ways. First, companies have capitalized on investor demand for high yield issuance by refinancing and extending their debt maturities. Second, aggressive management cost cutting has increased cash flow and enabled corporations to pay down debt.

The implication is that while spreads have moved quickly to reflect a more realistic view of upcoming defaults, they may still be discounting too high a rate. Specifically, the current high yield spread implies a default rate of around 8% over the next 12 months. This rate stands above the 6-7% level that historical precedent would suggest at this stage of the recovery, as well as the 6.9% and 4.4% forecasts of Moody's and Standard & Poor's, respectively. As such, we see scope for further spread compression, supporting an annual expected return of around 7%.

Conclusion

As we head into 2010, the world's economies and markets are dealing with powerful reverberations from the economic crisis of 2008-2009. Some of these – such as high levels of unemployment and fiscal imbalance – are particularly acute in the US, where the recovery is still nascent. Against a backdrop of highly robust and apparently sustainable growth in emerging economies such as China, it's no surprise that some pundits have declared this to be the end of US dominance on the global financial stage.

But we disagree. As we've discussed, both history and current factors make a clear and compelling case for continued US influence in the world. We've seen in the past very convincing and well-subscribed arguments proclaiming the demise of the US, and in every case, they've been incorrect. We see today the unparalleled magnitude of the US's power – not just militarily, but also socially, politically and economically. Financially, we believe the US will offer an attractive source of relative investment returns in the year ahead, from its undervalued dollar to its reasonably priced equity market. And we see the stamp of America's unique culture, attitude and outlook in every corner of the globe.

We believe that 2010 will see the continuing emergence of fast-growing economies such as China and India, but we don't think their success will cost the US its leadership position – this year or any other for the foreseeable future. ■

Footnotes

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