CAPITAL MARKETS PERSPECTIVES

Weekly Market Review

Week ended **February 26th**

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Uncertainty Weighs on Markets Despite Sound Fundamentals

The U.S. stock market ended last week down slightly, having spent the previous five days trading in a narrow range—much as it has since the fall of 2009. International equities lost slightly more ground last week. Developed market international stocks are now essentially where they were six months ago, and emerging market stocks have posted only single-digit gains over the same period.

Stocks have languished in recent months even though bottom-up, or stock-by-stock, market fundamentals are generally sound. Though there are convincing signs of recovery in the U.S., and last week brought more evidence of outsized economic growth in emerging markets, certain key areas of uncertainty continue to weigh on returns.

U.S. recovery intact

In the U.S., over 70% of companies thus far reporting fourth-quarter 2009 earnings beat expectations, bringing annualized earnings for the S&P 500 Index to approximately $78 per share. At the index's current levels, it's trading at approximately 14 times fourth quarter 2009 annualized earnings—not an excessive level by historical standards.

U.S. Gross Domestic Product was revised higher last week, to a 5.9% annualized gain from an initial estimate of 5.7%. **U.S. industrial production** has surged recently, rising 9.7% over the last seven months as manufacturers move toward inventory accumulation and businesses boost their capital expenditures. This rebound in production is stronger than the recoveries of 1975 and 1983.

Meanwhile, mergers and acquisitions have also been picking up in another positive sign for the U.S. economy. Witness the epic battle currently underway between Simon Property Group and Brookfield Asset Management for mall owner General Growth Properties.

Monetary policy remains accommodative in the U.S., reflected in low interest rates on government bonds: As of February 26, the two-year Treasury yielded 0.80%, while the 10-year Treasury yielded 3.61%[1], despite a 25 basis point hike in the discount rate on February 18th. Federal Reserve Chairman Ben Bernanke must be pleased.

Though Bernanke offered little in the way of concrete guidance in a speech to Congress last week, rates are likely to remain low for the foreseeable future. The exact timing of the first rate hike in the next tightening cycle remains in question. Improvement in employment will be key to any such move, however, the Fed is not going to start tightening rates before jobs start coming back. This could mean a raise in rates in the second half of 2010 or early 2011, but remember: from the standpoint of crimping growth, it's not the first rate hike that matters, it's typically the last. (You may recall that in the last cycle, the Fed began raising rates in 2004, and the markets rallied through 2007. That's not a prediction, just an observation.)

1 Source of Treasury Rates: Bloomberg as of 2/26/10.

Emerging-market growth still strong

Emerging markets continue to grow strongly as a whole, with Thailand and Taiwan both posting very robust Gross Domestic Product (GDP) figures for the fourth quarter of 2009 last week. It's also worth noting that the Brazilian real climbed 4.3% against the dollar in February, a reflection of strong growth and an expectation that Brazil will raise interest rates soon.

A world of uncertainty

What's keeping markets in a tight range—despite strong fundamentals at home and solid growth in emerging markets—is old-fashioned uncertainty.

In the U.S., this took the form of a worse-than-expected reading of the Conference Board's **Consumer Confidence Index.** The gauge fell to 46.0 from January's revised 56.5 reading, with expectations registering at low levels and present-condition readings nearly at levels last seen in the early 1980s.

The report is something of an outlier—it's not totally consistent with other recent consumer sentiment surveys, though it does gather more responses about employment than the University of Michigan's **Consumer Sentiment Index** (which showed virtually no change in its latest reading). The Conference Board data is also inconsistent with recent reports on same-store sales, retail sales, auto sales and others. It seems that the intense negativity suggested by the Consumer Confidence Index doesn't fully reflect consumers' actual behavior.

Regardless of which data point paints the "truest" picture, it's clear that there's plenty of negativity weighing on the markets. This isn't surprising, as unemployment remains high, Washington, D.C. seems consumed by political fighting and the housing sector appears unlikely to rebound anytime soon. Last week's reports on both new and existing home sales were disappointing, mortgage applications were down heading into real estate's traditional selling season and it is likely there are more mortgage delinquencies forthcoming, particularly as home prices potentially face another leg down in prices. Improvements in the job picture should lessen the blow and importantly the banking system is capitalized well enough to handle future losses. For his part, President Obama is seeking to ban foreclosures unless borrowers first try to resolve their debt issues through the Home Affordable Modification Program. Either way, an "L-shaped" recovery in housing may be the most optimistic outcome at this point.

Negativity is on the rise overseas, too—at least in Europe. Social and political tensions are growing as several of the eurozone's fiscally weaker countries—mainly Greece, but also Portugal, Spain, Ireland and, to a lesser extent, Italy—try to address high budget deficits. An actual Greek default on its debt would have considerable implications for German ($43.2 billion exposure to Greek debt) and French banks ($75.5 billion) and cause a spillover effect for other high debt countries in the region. A different option calling for Greece to exit from the Euro would likely be an even worse outcome as investment flows would dry up as investors size up the next country to drop in Europe. Neither a default nor an exit from the Euro is the likely outcome. Rather, Greece is likely to have to institute very severe austerity measures to bring down the deficit, but these measures could crush economic growth. Doing nothing is not an option, however. The country needs to raise EUR53 billion in the debt markets this year, but its deficit problems have already driven borrowing costs to untenable levels—and its sovereign debt may be on the verge of a credit rating downgrade, which could push borrowing costs even higher. Overall, it's difficult to imagine how Greece can bring its deficit to the maximum of 3% of GDP mandated by eurozone rules without external financing.

Though uncertainty may be high in many areas, it's important not to lose sight of the market's many potential opportunities. Investors should focus on quality earnings—those driven by meaningful profitability growth, not just greater efficiency or favorable comparisons with last year's results. Given the low yields offered by Treasury bonds, investors may also be well-served to concentrate on corporate bonds, whose spreads over Treasuries remain attractive. Overseas, emerging-market equities may face short-term volatility, but they present a tremendous longer term growth story. International fixed income investors may be rewarded by focusing on

sovereign issues of countries that are growing and can fund their own debt needs.

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