CAPITAL MARKETS PERSPECTIVES

Insights & Outlook 3RD QUARTER 2010

Investors today have plenty to be concerned about, from the ongoing European sovereign debt crisis to an uncertain global regulatory future. Such concerns shouldn't, however, obscure the fact that the global markets are ripe with opportunities for the shrewd investor. In this issue:

Jerry Webman, Chief Economist, revisits his Top 10 themes for 2010. Among his observations:

- The U.S. economy is still on reasonably sound footing, and interest rates are set to remain low for a long time
- Widening fixed income spreads have created opportunities for investors
- The cyclical rally in the U.S. may still have legs, and emerging markets appear set to continue their long-term secular expansion

Chris Leavy, CIO Equities, argues that despite the gloomy headlines, high quality growth companies offer characteristics even a skeptic can appreciate, including

- A remarkable ability to generate cash
- A history of maintaining margins, sales and earnings in difficult market environments
- Attractive valuations

Art Steinmetz, CIO Fixed Income, examines the differences between fiscally sound countries with favorable demographics, and heavily indebted, policy-constrained nations, concluding that

- Emerging markets offer debt investors some of the best potential opportunities
- Developed markets, especially in Europe, continue to face serious challenges
- The U.S., despite high debt levels, has a range of factors working in its favor

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Global Economic Forecast

The economic recovery is underway. Forthcoming second quarter gross domestic product (GDP) results are likely to show that global growth is at or near peak levels.

Positive	**Interest Rates**	Sovereign debt crisis led to lower government borrowing costs in the world's largest economies and likely keeps Fed policy accommodative for the foreseeable future
	Price Stability	As policymakers in select emerging markets work to clamp down on inflation and developed economy labor markets are weak, prices remain stable in the U.S. and most other developed economies
	Corporate Earnings	Companies continue to benefit from improved global demand and remarkable productivity. The trajectory of earnings growth will moderate with businesses investing more in labor and capital
	Manufacturing	Sector is shifting from rapid growth fueled by an inventory rebuild to more modest but sustainable levels of production driven by pent-up consumer and business demand
Neutral	**Global Growth**	With the notable exception of the countries of peripheral Europe, a double dip recession is not in the offing for most of the world's major economies
	Employment	Unemployment in the U.S. remains near a 17-year high and high levels of layoffs persist. The private sector has, however, created 495,000 net new jobs in 2010. A sustained economic expansion requires an acceleration in job creation
	Credit Environment	The environment has normalized considerably but lending to small businesses remains anemic. Borrowing costs for high quality businesses and municipalities remain accommodative
	Consumer Spending	The demise of the U.S. consumer has been greatly exaggerated, but high unemployment precludes consumer spending from being an asset
Negative	**Trade Balance**	U.S. exporters further benefit from strong growth in the emerging world but trade likely detracts from GDP with exports to Europe moderating, a weakened euro making European exports more competitive, and imports increasing as the U.S. economy improves
	Budget Deficit	A growing U.S. federal deficit, potentially worsened by state and local governments' financial straits, threatens to push both taxes and interest rates higher, weakening growth
	Housing	With prices stabilizing and mortgage rates declining, the housing market continues to hold its floor. The still-bloated inventory levels prevent a breakout to the upside. As with cash for clunkers, the expired mortgage tax break caused a positive then a negative deviation from a trend that will reestablish itself

10 for 2010: Mid-Year Review

Jerry Webman, Chief Economist

On the eve of 2010, I highlighted our top 10 themes for the coming year. Let's take a look at how those themes progressed over the first half of the year.

1. A Continuation of Economic Growth

U.S. economic activity continues to improve, but breakout growth remains stubbornly out of reach and concerns remain. The key drivers of the economy are generally advancing, leaving it less vulnerable to external shocks emanating out of Europe. Housing prices appear to be bouncing along a bottom, mortgage rates are trending lower, bank lending standards are easing, global growth (excluding Europe) is solid, payrolls are improving and purchasing manager surveys are strong. The U.S. also enjoys the stimulus of fiscal spending, low Treasury rates, and a Federal Reserve that's likely on hold for a long time. The next phase of U.S. growth is likely to be less robust than periods following past recessions, and leading indicators appear poised to roll over, but the economy is still on reasonably solid footing.

2. Fed Keeps Short-term Rates Low for the Long Term

The Fed, having completed its purchases of mortgage-backed securities and having phased out its emergency lending facilities, is starting to lay the groundwork for further normalization of monetary policy. The Fed will employ the novel policy tools at its disposal (paying interest on reserves, reverse repos) but will likely leave interest rates low for the foreseeable future. The European sovereign debt crisis only delays the beginning of the tightening cycle. Inflationary pressures, and perhaps more importantly, inflation expectations, remain at bay as wage growth remains modest and businesses work below capacity.

3. Rising Treasury Rates

The most widely held forecast heading into 2010 called for U.S. Treasury rates to rise. Beware the consensus; the call has been flat wrong. Rates tumbled in May and June amid fears over a destabilized European banking system, mixed data in the U.S., and policy restraint in emerging markets. The original rationale for higher rates was clear. Improving economic conditions and widening corporate profit margins at a time when the Treasury was coming to market with a mountain of new debt would result in treasuries appearing riskier and alternatives less risky. My pithy comment at the time was that supply would be the enemy of price. In the long run I still believe this to be true. The U.S. can continue down the current fiscal path as long as the government can refinance its debt at low rates, and for now large U.S. debt holders have little alternative but to support the U.S. Treasury market. The bond market will eventually force our hand unless our politicians pass and enforce a long-term deficit management plan.

4. Credit Risk over Interest Rate Risk

Spreads narrowed until mid-April as investors gained confidence in the economy and increasingly reached for yield. The recent flight to quality that drove Treasury rates lower also increased borrowing costs for lower rated companies and municipalities. This story isn't over either, as indiscriminate selling as the economy continues to recover has created further opportunity for income-oriented investors.

5. Dollar Support...But Not Against All Currencies

It's a great irony that heading into 2010 I was often asked to address the fear that the euro would somehow overshadow the dollar's reserve currency status. This fear was always misplaced. As the euro's strength versus the dollar was coming under increased scrutiny, I wrote:

A dollar/euro exchange rate of 1.45 to 1.50 confronts the European Union's reliance on exports and raises the threat of deflation for the region's weaker economies. Further, the population of Europe as a percentage of world population is decreasing more rapidly than that of the U.S. and in some countries has begun to decline absolutely. This demographic challenge will curtail the region's growth rate substantially and strain its public finances as its baby boomers retire and life expectancy increases.[1]

The recent flight to quality has led to dollar appreciation against not only the euro, but many major currencies of the world. Our view remains the same. Money, over time, will flow to higher growth countries, depreciating the greenback relative to many of the currencies of East and Southeast Asia and Latin America.

6. Cyclical Stock Rally in U.S. Has Legs, but Fades by the End of the Year

The S&P 500 Index hit a cyclical peak of 1,217 on April 23, 2010, on the strength of a sharp rally that began in early February.[2] The rally lost steam earlier than I expected amid concerns that Chinese policy restraint and the European sovereign debt crisis could derail the U.S. economic recovery. Conditions for a double dip recession in the U.S. are not in place, and equity valuations appear to be reasonable given the likely trajectory for earnings. The long-term

headwinds remain, but the cyclical rally in the U.S. may still have legs. A tougher market will increasingly put a premium on sustainable earnings growth.

7. Emerging Market Equities Pullback

Conditions were ripe for a pullback. Valuations had become over-extended and the common prerequisites for over-exuberance—low global interest rates, yawning gap in growth potential between the emerging and developed worlds, pegged exchange rates—were evident. As conditions became frothy in select emerging market economies, policymakers rightfully began to tighten the purse strings. Investors responded with trepidation, sending the MSCI Emerging Markets Index down about 8% since the beginning of the year.[2] In fact, steps to slow these economies from unsustainable levels are sound policy and good news. The long-term fundamentals—the expanding middle classes, the growing cities, the burgeoning consumer classes, the improving budget pictures—have not changed. Policymakers' efforts to "stick the landing" in 2010 set the stage for continuation of long-term secular expansion.

8. China Reduces Highly Stimulative Credit and Currency Policies

China continues to lead the emerging economies' great leap forward. The export engine still purrs while a burgeoning consumer class drives domestic demand. Overheating and inflation threaten, however, and price indices are now slightly above the People's Bank of China's assumed targets. Prudently, policymakers have taken steps to tighten credit availability and temper housing speculation; the Shanghai Index declined sharply in response. The recent decision to allow the Chinese yuan to float within a trading band is yet another step by Chinese policymakers to moderate growth in the potentially overheated economy.

9. Federal Regulatory Reform Progresses

As we went to press, financial regulation reform looked set to pass imminently. The key provisions include:

- **Volker Rule 2.0**—Prohibits proprietary trading at banks with access to federal deposit insurance, but banks will still be able to make investments up to 3% of their Tier 1 (or "core") capital in private equity and hedge funds
- **Limits on derivatives trading**—Limits banks' derivatives activity to in-house trading of foreign exchange and interest rate swaps, as well as gold and silver swaps and other derivatives used to hedge risk. The legislation will also place derivatives trading under federal oversight and require that most derivatives transactions be insured by a clearinghouse and executed on public exchanges
- **Curtailing "Too big to fail"**—The new regulations attempt to create a process through which the government can liquidate failing companies in an orderly fashion and at no cost to taxpayers. (I don't look forward to testing that theory)
- **Other provisions**—The regulations include a range of other measures aimed at protecting investors and consumers, such as giving shareholders a nonbinding say on executive compensation and requiring companies that sell certain financial instruments to retain some of the risk. The regulations also creates a new agency to write and enforce consumer-protection rules for mortgages, payday loans and checking accounts, among other financial products

As centuries of horse-out-of-the-barn legislation demonstrates, financial crises will recur whatever restrictions—wise and unwise—the bill imposes. This round will likely extend the U.S. banking system's deleveraging process with banks holding more reserves and employing more stringent lending requirements for households and small businesses.

10. I Pray Not, but...

The probability of a significantly disruptive geopolitical event remains high. Security concerns need to continue to play a role in our future planning—including financial planning.

Stocks Even a Skeptic Can Appreciate: High Quality Growth Companies Offer Enduring Advantages

Chris Leavy, CIO Equities

With the global economy lurching from one crisis to another over the last few years, market volatility has risen, and gun-shy investors often appear ready to flee from risk at the first sign of trouble. The falling global stock prices this summer has created a great opportunity to buy some of the world's finest companies on the cheap. In this commentary, we will highlight both how cheap many of these high quality growth stocks have become, and how little investors have to believe in order to get a favorable long-term return outcome. We think even those who are skeptical about where the world is going can find opportunities among high quality growth stocks.

What is a high quality growth stock?

Before we lay out our investment case for high quality growth stocks, let's pause to define what, exactly, a high quality growth company is. We use this somewhat nebulous term to describe corporations that have three defining characteristics:

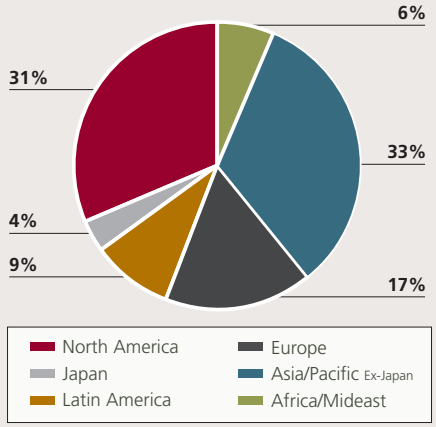
1. A competitive advantage or industry structure that enables high returns on capital
2. Opportunities to grow their businesses at faster rates than the overall global economy
3. An absence of excessive financial leverage

Inditex,[4] an innovative Spanish clothing retailer, would be an example of a global company with a distinct competitive advantage. It controls the Zara brand and specializes in bringing fashions to market faster than competitors. High quality growth companies may offer other, related advantages, such as having superior brands that create pricing power (e.g., Colgate-Palmolive[4]); possessing valuable intellectual property; operating in an oligopolistic market (i.e., one in which just a handful of players dominate), or enjoying economies of scale (e.g., Taiwan Semiconductor Manufacturing Company).[4]

Quality Growth Companies Across Regions and Sectors[3]

Regions of Domicile

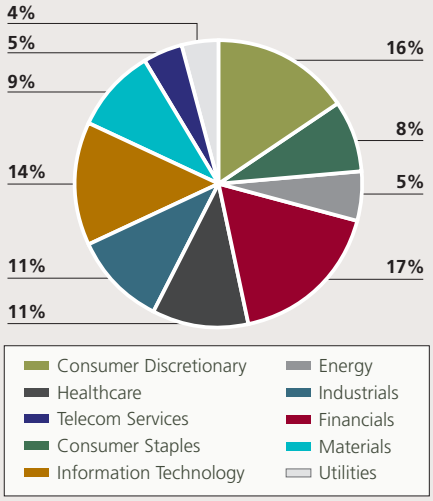
Top quintile quality and growth companies within the MSCI All Country World Index, as of 6/25/10.



Source of chart data: Bloomberg, 6/25/10.

Sectors

Top quintile quality and growth companies within the MSCI All Country World Index, as of 6/25/10.



Source of chart data: FactSet, 6/25/10.

An under appreciated ability to generate cash

High quality growth companies offer more than just a litany of qualitative advantages. The investment case for these companies also rests in large part on their outstanding ability to generate cash. Thanks to high returns on capital, many can generate meaningful free cash flow (the cash left over after a company has paid its cash expenses and capital expenditures) *while they continue to grow their business.*

In fact, high quality growth companies have converted about 88% of their earnings into free cash flow over the last five years, versus the global corporate average of 74%.[5] Additionally, taking the free cash flow these companies have generated over the past twelve months, they post, on average, a free cash flow yield of 7.3% based on June 30, 2010 stock prices (even better than the overall global average of 6.5%).*[5]

To draw an analogy from the fixed income world, one can think of this 7.3% free cash flow yield as the "coupon" on these companies; if a share cost $100, it would have generated about $7.30 a year in free cash flow alone. Typically, not all of this cash is paid to investors in the form of dividends, so a portion of this free cash flow is often less

*Free cash flow yield is determined by dividing free cash flow by market capitalization.

visible, being used for activities such as share buybacks, "bolt-on" acquisitions or debt reduction. However, under prudent management teams, such cash uses tend to create shareholder wealth.

Also, unlike bonds, this "coupon" is likely to increase due to factors such as volume growth and price increases. Even in a scenario of modest 3%–5% real (inflation-adjusted) profit growth, investors would earn a real return of roughly 10%–12%: 7.3% from free cash flow and 3%–5% from real growth. Given the caliber of the companies we are discussing, we expect many of these companies to compound their free cash flow at faster rates over time. Past performance, however, does not guarantee future results.

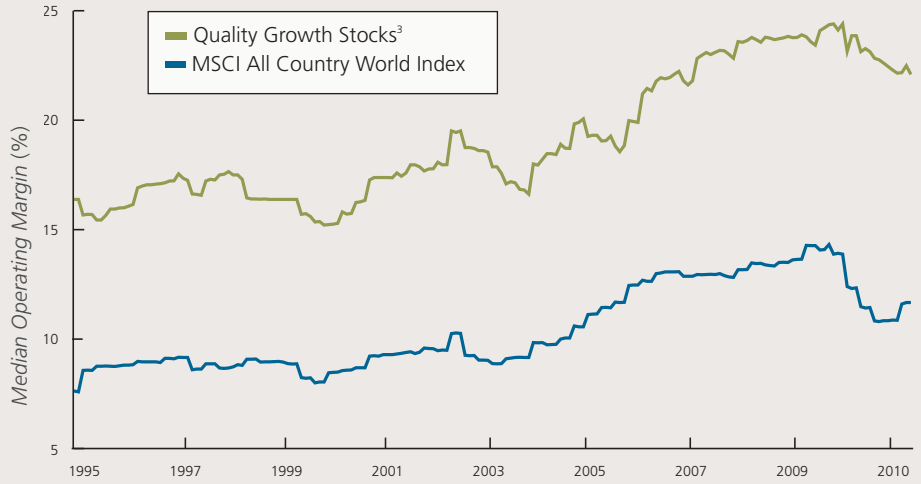
Given their structural advantages, these companies may also provide a natural hedge against inflation. Looking at quality growth companies as a group over the long term, we would expect any inflation pressures to push up both prices and costs by similar amounts. Thus, profits—the difference between price and cost—should provide a long-term hedge against inflation. In other words, each unit of inflation should increase nominal profit growth (e.g., 1% inflation will add 1% to profits) for this group of companies in the aggregate (although there will be relative winners and losers with inflation at the individual company level).

Remarkable resiliency in the face of turmoil

Normally, to pursue higher returns, investors must assume more investment risk. With high quality growth companies, however, this is generally not the case. Such companies have shown remarkable resiliency in the face of turmoil, as their inherent strengths enabled them to better absorb systemic economic shocks (compared to the average company).

Preserving Margins During Downturns 1/1/95 THROUGH 5/28/10

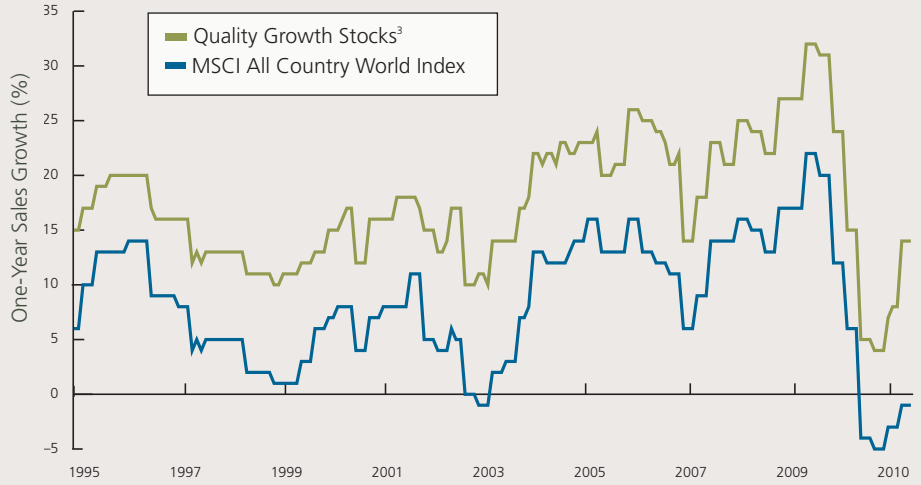
Median operating margin: Quality growth stocks vs. MSCI All Country World Index



Source of chart data: FactSet., 5/28/10. The MSCI All Country World Index (ACWI) is a free-float-adjusted, market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. Each index is unmanaged, includes the reinvestment of dividends, and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any Oppenheimer fund. **Past performance does not guarantee future results.**

Quality Growth Companies' Sales Weathered the Downturn Well 1/1/95 THROUGH 5/28/10

One-year sales growth (trailing): Quality growth stocks vs. MSCI All Country World Index



Source of chart data: FactSet., 5/28/10. The MSCI All Country World Index (ACWI) is a free-float-adjusted, market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. Each index is unmanaged, includes the reinvestment of dividends, and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any Oppenheimer fund. **Past performance does not guarantee future results.**

During economic downturns, companies without competitive advantages tend to lose both sales volume and pricing power, and consequently experience sharp declines in margins. In contrast, thanks to high quality growth companies' competitive advantages, their pricing power—and therefore margins—have suffered significantly less than other companies during times of economic stress. Note the better margin resiliency in the upper chart on the facing page during 2008 and 2009.

Quality growth companies also should experience more revenue resilience during tough times (and better revenue growth during good times) due to better pricing power, expanding addressable markets, market share gains and/or healthy expansion to the faster growing emerging market economies.[6] Ultimately, as the lower chart on the facing page shows, high quality growth companies on average maintained positive year-over-year sales growth even during the 2008–2009 downturn, when the typical company was losing ground.

Given how well their margins and sales have fared in difficult economic market environments, it should be no surprise that these companies also tend to show better earnings resiliency during times of economic stress. Such resiliency suggests that high quality growth stocks may have less exposure to systemic or macroeconomic shocks than their more run-of-the-mill counterparts.

Relative P/E Ratio Should Further Increase

While high quality growth stocks have cheapened in absolute terms with the recent global stock market decline, the relative price-to-earnings (P/E) ratio for the average high quality growth stock has expanded somewhat and no longer trades at the discounts to the broader market that we noted in previous commentaries (this is because the prices of many quality growth stocks went down less than the typical stock during the recent sell-off). As of June 30, high quality growth stocks trade at a P/E ratio on next year's earnings estimates of 12.3, a slight premium to the 12.0 P/E ratio of the broader global stock market.[5]

Looking at history, there are times when the valuation premium for quality growth stocks has become significant. We may be entering another such period when the relative P/E ratios for quality growth stocks reach meaningful premiums. The economic headwinds resulting from high debt levels in the developed world will likely create a challenging environment for simply average companies to thrive. Thus, the scarcity value of companies that can grow earnings (and maintain attractive returns on capital) should increase, leading to premium valuations for the average high quality growth company that continues to execute.

Importantly, even if P/E multiples remain stationary, we believe high-quality growth stocks are positioned to provide superior returns simply by growing earnings at a faster rate than their counterparts.

What it means for investors

The recent downdraft in stock markets has presented investors with an opportunity to buy many of the finest companies in the world at undemanding valuations. These companies' historical ability to weather economic downturns and generate significant attractive free cash flow makes them uniquely attractive—even for skeptics.

Separating the Wheat from the Chaff

Art Steinmetz, CIO Fixed Income

If it bleeds, it leads—so goes the old newsroom saying. Perhaps that's why horror stories of the bleak sovereign credit landscape have been garnering so much attention recently. Yet, while several countries certainly do face profound fiscal difficulties, the outlook is bright for many others.

The global growth story is clearly still intact. World Gross Domestic Product (GDP) grew 4.9% year over year in the first quarter of 2010, and is poised to have grown at about the same rate in the second quarter, according to consensus estimates.[7] Unfortunately, the European sovereign debt crisis continues to dominate headlines—and investor sentiment—along with the BP spill, slowing Chinese economic growth and other topics that are sure to furrow the collective brow.

The headlines that many seem to ignore, however, may be the most important of all. Brazil, India and China (yes, still) are enjoying double-digit growth rates, and growth remains strong in "dollar-bloc" nations—Australia, Canada, and New Zealand—and Latin America. Most of the world, in essence, is doing fine economically.

Yes, there are challenging years ahead for some. The repair of bank balance sheets in the wake of the financial crisis will take years. In the U.S., consumer deleveraging will continue to constrain growth. The temptation for some heavily indebted nations to debase their currencies in order to reduce the real value of their liabilities could prove almost irresistible, and many governments continue to write checks they won't be able to cash.

Nonetheless, opportunities abound. Many nations, particularly in emerging markets, have strong long-term growth prospects and are home to expanding, world-class global companies. Emerging-market consumers are likely to see their incomes continue to grow, which will help fuel demand, and therefore growth, for years to come. The expansion of credit from a very low base in many parts of the world should support increased consumption and help companies expand. And investor portfolio data indicate that the credit markets should be able to absorb plenty of new borrowing; there's a surprising scarcity of debt in many portfolios, but a large aggregate cash position. Eventually, investors are going to want a return on their money.

"Good" and "bad" economies: A taxonomy

To help identify potential opportunities, it's useful to divide the world into two camps—for the sake of convenience, let's call them the "good" and the "bad" (a judgment solely on their fiscal and demographic positions, of course).

The "good" countries enjoy policy flexibility and have

- Modest debt and fiscal deficits as a percentage of GDP
- Favorable demographics
- Supportive (or improving) business climates

Examples of such countries include Australia, China, Chile, Indonesia, South Africa and Turkey. Most fulfill at least the first two criteria, though doing business can still be challenging in some.

The "bad" countries, by contrast, are policy constrained. They tend to face

- High debt-to-GDP levels
- Growing deficits and debt service costs
- Aging populations (which drive ballooning entitlement costs)
- Entitlement programs that are indexed to inflation (which makes inflating away deficits impossible)
- Hurdles to new business formation

The list of "bad" countries would include Japan and many of those in southern Europe.

The "good"

Let's take a look at what's happening in the "good" countries first. Represented heavily (but not exclusively) within emerging markets, this group is enjoying strong economic growth, driven in part by higher savings and investment ratios (see upper left chart on next page). In many cases, domestic demand is increasingly substituting for exports.

This is the case in China, for example. Wages have risen in China every year for the last 15 years, though not quite as fast as GDP. Yet, continued wage hikes—especially against the background of recent labor unrest—have raised questions in some quarters about whether China can remain the low-cost workshop of the world.

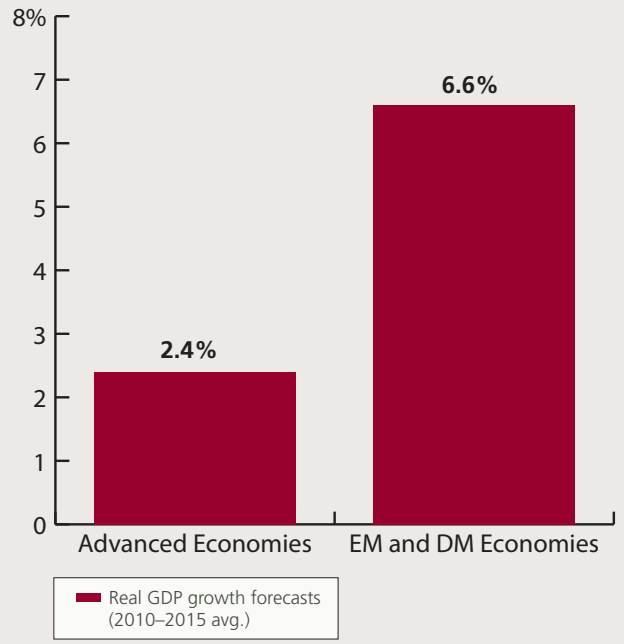
Such concerns are understandable, but we believe the rise in Chinese incomes is a "glass-half-full" story. Labor's share of income fell to 39.7% of GDP in 2010 from 53.0% in 1999, but that trend seems poised to reverse as fewer new workers enter the labor force in coming years.[8] Consequently, we expect per capita income levels to rise dramatically, driving much faster consumption growth. As incomes rise, so may demand for housing, replacing speculation as a key driver of real estate investment in the process.

Brazil is another example of a country that is increasingly deriving economic growth from domestic demand rather than exports. With a large, relatively closed economy, Brazil has long been fairly reliant on

Emerging Markets Increasingly Fall into the "Good" Category[9]

Real GDP Growth Forecasts

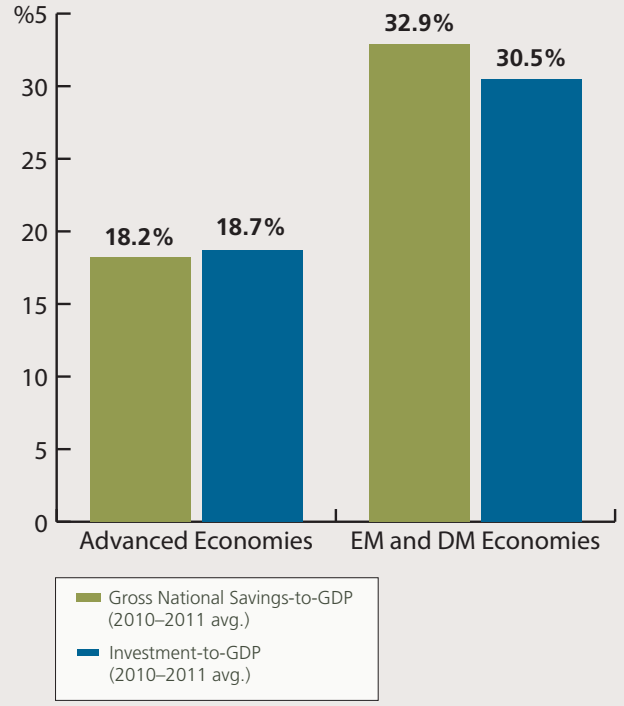
Estimated growth as a % of GDP, 2010 through 2015 (estimated)



Source of chart data: International Monetary Fund, World Economic Outlook Database, April 2010.

Savings and Investment Forecasts

Savings and investment rates as a % of GDP, 2010 through 2011 (estimated)



Source of chart data: International Monetary Fund, World Economic Outlook Database, April 2010.

domestic demand, but as incomes rise, so should consumption (fully half of Brazilians are now in the middle class, by some measurements).

Most of our "good" countries have several other key attributes working in their favor. Their central banks resist currency appreciation by accumulating foreign reserves, which play a defensive role in times of financial turmoil. Their governments tend to run counter-cyclical monetary policies, raising or lowering interest rates to stabilize growth rates and fight inflation. Their strong fiscal positions also mean that they can increase spending when necessary without assuming an unsustainable debt burden, and their generally young workforces (with some exceptions, like China) are likely to be able to support national pension schemes for years to come.

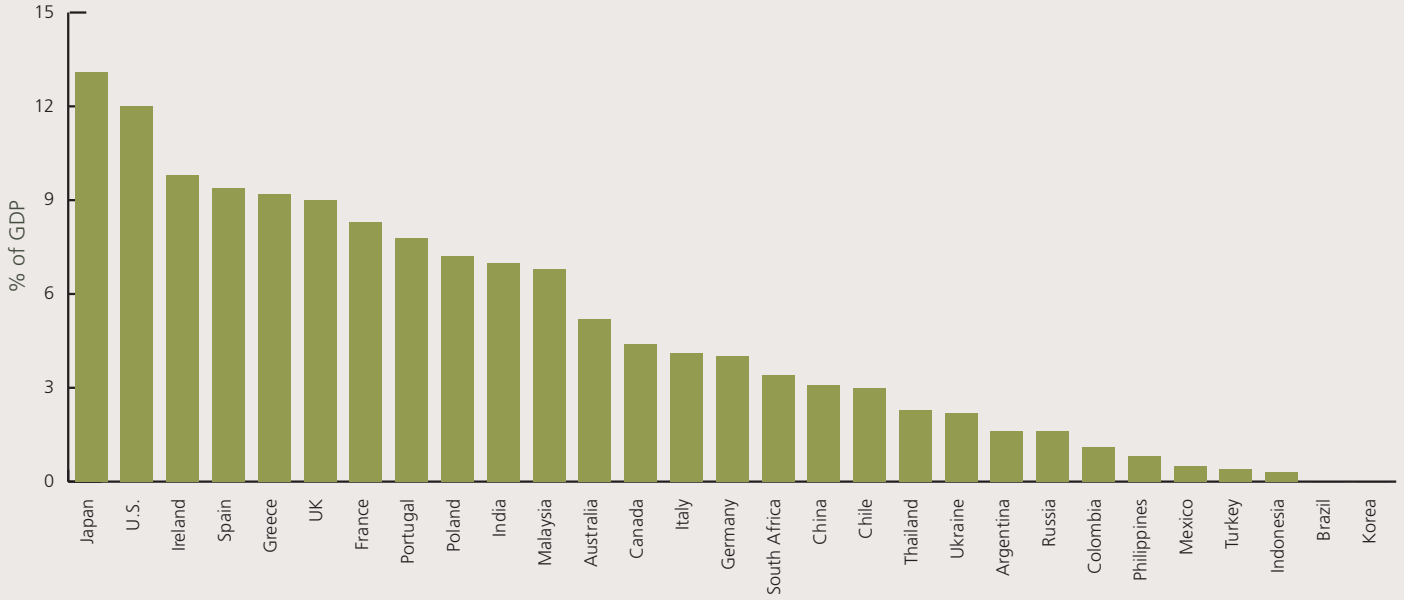
Of course, it's important to note that despite their strengths, emerging markets are by no means perfect. Many have strengthened their financial positions in part as "insurance" against spotty, if improving, governance and institutional structures. Having said that, it seems clear that the line between developed and emerging markets is blurring, and that it no longer makes a lot of sense to hold emerging markets countries to a different standard, as markets traditionally have.

The "bad"

The "bad" countries are in an altogether different position. Developed markets, which constitute a significant part of this beleaguered club's membership, used to get a pass on spending, as their borrowing capacity was thought to be virtually unlimited. Central banks, after all, could just print more money. The stimulus packages many countries enacted in 2008 (particularly in the developed world) disproved this assumption and effectively "maxed out" these countries' borrowing capacity. Credit quality now matters for developed-world governments, just like it does for emerging markets. Higher interest rates for much developed-world sovereign debt reflect this new reality—and in some cases mean these countries can no longer afford to borrow money.

Achieving Sustainable Debt Levels Will Be Tough for Some

*Needed fiscal adjustment between 2010 and 2020 to achieve debt target in 2030**



Source of chart data: International Monetary Fund, World Economic Outlook Database, April 2010. *Needed fiscal adjustment between 2010 and 2020 to achieve a general government gross debt to GDP ratio of 60% in advanced economies (or to stabilize the debt ratio at the 2012 level if it is already below 60%) by 2030 and a general government gross debt to GDP ratio of 40% in emerging economies (or to stabilize the debt ratio at the 2012 level if it is already below 40%).

Most of the nations in our "bad" category suffer from problems related to public sector employment. Public sector workers in these countries tend to be more highly paid than those in the private sector, and are entitled to extremely generous pensions—often amounting to greater than 100% of their working wages. Meanwhile, retirement ages tend to be quite low, which, combined with an aging population, means younger workers will have to shoulder a huge burden. Among some of these nations, wildly inefficient tax collection practices and a substantial "gray" economy depresses government revenues, while legitimate businesses are often difficult to incorporate.

So, what are the choices facing the "bad" countries? Their options are to

- **Grow the economy and therefore debt service capacity**—In an ideal world, the "bad" countries could just grow themselves out of fiscal trouble. Unfortunately, growth can't be willed into existence, especially in the absence of business-friendly policies and what would be massively unpopular public sector cuts. The growth option is a long-term solution in the best of cases
- **Inflate to devalue debt**—Inflation, which under other circumstances would lower the real value of a country's debt, generally wouldn't actually reduce debt burdens, because benefits are indexed to inflation almost everywhere
- **Devalue currency**—Currency devaluation stimulates exports but also lowers living standards if consumption is dependent on imports. Unlike Greece, the U.S., for example, has exports that are sensitive to a lower currency, but, like Greece, consumption is dependent on imports. Devaluation also raises the cost of foreign exchange liabilities, so default tends to accompany devaluation
- **Default**—Defaulting on debt would "restart the clock," in a sense. However, without a structural fix, the underlying problem (that the state's obligations will outstrip its ability to pay) would just start to grow again—but this time, markets would not finance it
- **Cut spending**—Slashing spending is "bad" countries' only real solution, but also the least likely to happen, since doing so is generally tantamount to political suicide. Token cuts may be acceptable to voters, but at some point, cutting spending becomes seen as reneging on obligations to public sector workers instead of bondholders, as would be the case in a default

Essentially, "bad" countries have to navigate between the Scylla of default and the Charybdis of spending cuts (appropriately enough, these two mythological sea monsters were said to live in the Mediterranean). Governments looking to cut costs will inevitably seek greater enforcement of tax laws and try to raise the average retirement age, as we've seen in Greece and elsewhere. Cutting medical expenses (i.e. benefits) and reducing pensions will be a much harder sell.

What about the U.S.?

The U.S., for its part, falls somewhere between the "good" and "bad" categories. Like many European counterparts, the U.S. suffers from high debt and deficits, and politically untouchable entitlement spending continues to grow. Unlike much of Europe, however, the U.S. has moderate-to-good growth potential, flexible labor markets and a relatively friendly business climate. Other factors working in favor of the U.S. include a currency that can adjust with market dynamics, boosting exports if it declines, and a pattern of net immigration, which can help offset otherwise unfavorable demographic trends.

What it means for investors

Given the huge structural divide between the "good" countries and the "bad" ones, it seems clear that, from an investor's point of view, emerging market debt looks to be the big winner and European debt (particularly that of peripheral countries) looks to be the biggest loser. U.S. debt, for its part, is a mixed bag.

CAPITAL MARKETS PERSPECTIVES

Insights & Outlook Summary

- **ECONOMIC OUTLOOK**
- **EQUITIES OUTLOOK**
- **FIXED INCOME OUTLOOK**

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1. OppenheimerFunds' *Eye On the Markets*, December 2009.
2. Source of data: Bloomberg, 6/10/10.
3. For the purposes of this article, we determined the universe of high quality growth stocks by scoring each company in the MSCI All Country World Index according to a variety of "Quality" and "Growth" factors. Quality factors included return on equity, return on invested capital, operating margin, free cash flow margin, debt-to-assets and sales growth stability. Growth factors included sales growth, growth in earnings per share and growth rate sustainability. The Quality and Growth scores were averaged to create a final composite score, which was then divided into quintiles. The top quintile forms our universe of high quality growth stocks.
4. The mention of specific companies in no way implies that Oppenheimer mutual funds invest in them, nor does it constitute a recommendation by any particular fund or by OppenheimerFunds, Inc.
5. Source of data: FactSet, 6/30/10.
6. Among the high quality growth companies we identified that disclose such information, fully 36% of their sales came from emerging markets. Two caveats: more than half of the companies we researched do not provide regional sales data, and the percentage of sales from emerging markets varies greatly by company. Also, this percentage includes some companies that are domiciled in emerging markets.
7. Source of data: Bloomberg, 6/30/10.
8. Source of data: Reuters, 6/2/10.
9. For the purposes of the charts in this article, developed economies are considered to be Australia, Canada, France, Germany, Greece, Ireland, Italy, Japan, Portugal, Spain, the U.K. and the U.S. Emerging markets are Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Philippines, Poland, Russia, Singapore, South Africa, Thailand, Turkey and Ukraine.

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