Executive Summary

Economic Outlook

- The global economic recovery appears solid and sustainable.
- The U.S. economy has so far outperformed expectations. The recovery in consumer spending should be sustained as employers add to payrolls in 2010.
- Business investment should remain a strong contributor to growth as demand picks up and corporate cash levels are high; however, housing appears to be stalling at low levels.
- Inflation is still not a near-term threat for the advanced economies, as large output gaps will take time to work off and broad money growth remains weak.
- Major central banks should remain on hold until the second half of 2010, at the earliest.
- While growth expectations for the U.S. and Japan have improved, they have not done so in Europe due to sluggish domestic demand and sovereign debt issues weighing on sentiment.
- Emerging market central banks are tightening policy to head off overheating and nascent inflationary pressure. We believe this is the right course of action to prolong the expansion, and we foresee a benign outcome.

Market Outlook & Investment Strategy

- The macro environment remains supportive for risk assets as the global recovery remains intact, corporate profits continue to beat expectations, and policymakers are holding rates at very accommodative levels.
- Valuations are much less appealing than a year ago; however, equities and other risky assets should be able to grind higher. A period of consolidation may be necessary before the next up-leg.
- Longer-term bond yields have drifted upward, but the hurdle rate for stocks to outperform cash and government bonds is still low.
- We expect Treasury Inflation-Protected Securities (TIPS) to continue underperforming nominal Treasury bonds.
- Select fixed-income risk assets should continue outperforming Treasuries. We still like high-yield and high-grade corporate bonds and emerging market debt.
- We are expressing our equity overweight through U.S. and emerging market stocks. We have shifted to a neutral position on EAFE markets.
- Emerging markets underperformed U.S. equities in the first quarter; however, we think outperformance will resume once investors feel comfortable that growth will continue despite policy tightening.
- We would stay underweight REITs, as valuations are stretched. While commercial real estate prices have probably bottomed, fundamentals are likely to remain weak until employment growth picks up steam.
Economic Outlook

The global economic recovery appears solid and should develop into a multi-year expansion. A double dip recession appears unlikely barring an unforeseen extreme shock. The recovery in the United States has so far exceeded expectations. Consensus forecasts of U.S. growth for 2010 have been revised upward to 3.1% from 2.7% three months ago. Questions still remain regarding the strength of the recovery going forward. The economy posted a 5.9% annualized growth rate in the final quarter of 2009, but 3.9% of that number was due to inventory restocking rather than genuine demand. Chart 1 illustrates that the upturn in real final sales to domestic purchase (a measure of final demand) has been more tepid.

Recent economic data support the notion of a muted but sustained recovery. Initial unemployment claims are falling but remain very elevated, and the unemployment rate is still hovering close to 10%. Furthermore, the recovery in the housing market—the collapse of which was the genesis of the recent financial crisis—seems to have stalled (Chart 2). However, even in the face of continued economic headwinds, consumer spending was a positive contributor to fourth-quarter GDP and is expected to expand further in 2010 as companies begin to ramp up employment. Businesses flush with cash, and becoming more optimistic as revenues and earnings continue to improve, increased investment at a 6.6% annual rate in the fourth quarter. We expect this trend to continue as companies need to replace older equipment to maintain high productivity and as overall demand picks up. Furthermore, the ISM surveys for manufacturing and non-manufacturing companies are in expansion territory overall, and in particular show consistent improvement on the employment front.

The recent inflation data support our view that inflation is not a near-term threat for advanced economies. The enormous economic slack generated during the Great Recession is filtering through all of the closely followed inflation statistics. Underlying inflationary pressure is nonexistent, as the 3-month annualized core inflation rate was flat for both January and February (Chart 3). Prices further back in the production pipeline are pointing to further downward pressure on goods prices, while housing (40% of CPI) has little pricing power, as this segment of the economy appears to be stagnating. With our view of a fragile recovery, no threat of inflation in the short term, and still-tight lending conditions, we believe central banks in the advanced economies will maintain a supportive policy stance into at least the second half of 2010.

The global decoupling between advanced and emerging economies continues to be reflected in the most recent data, as China is once again generating double-digit growth rates, while most of the advanced world is growing well below potential. To avoid overheating, China and other emerging economies are proactively tightening policy to cool off inflation without derailing growth. We believe this is the correct course of action and lends credibility to these central banks, which are attempting to balance inflationary pressure and healthy growth rates while trying to avoid a “bubble” scenario. Europe is becoming more of a concern, with growth forecasts being revised downward due to sluggish domestic demand, in addition to the ongoing sovereign debt situation (Portugal was just downgraded by Fitch). This is creating pressure on the Euro, which has fallen more than 6% versus the dollar year to date.

1 According to data from the survey organization Consensus Economics.
Investment Outlook

Risk assets had a bumpy ride during the first quarter but ended on a very strong note. Market jitters in early 2010 were mainly driven by increased fears of sovereign defaults in peripheral Europe and Chinese policymakers clamping down on bank lending to rein in booming growth. In early February, we recommended taking the opportunity to move to a modest equity overweight relative to fixed income and beef up exposure to U.S. high-yield bonds while trimming core investment-grade bonds. A continued stream of better-than-expected U.S. economic data, increased confidence of forthcoming assistance to the government of Greece and the Fed’s reaffirmed pledge to keep rates near zero for “a considerable period” all helped turn things around in March.

We remain concerned about long-term issues related to the aftermath of the Great Recession. Record stimulus succeeded in bringing us back from the brink, but at the cost of a shocking deterioration in government finances. The crisis in Greece is a shot across the bow to heavily indebted economies. If governments do not take proactive steps to bring fiscal deficits under control within the next couple of years, they may be forced into drastic action under the duress of another financial crisis. However, timing is everything in investing, and we still think the “tipping point” here lies beyond the next couple of years.

Meanwhile, the cyclical environment remains supportive of further gains in risk assets. The global economic recovery continues at a decent pace. Huge economic slack in the advanced economies means inflationary pressure is non-existent and major central banks can keep monetary policy at easy settings. Corporate profits are still beating expectations while cash on the sidelines, although down significantly from records levels, is still high historically and earning next to nothing in interest.

Hence we still think risk assets will outperform cash and government bonds. As we mentioned last quarter, however, the margin of outperformance is likely to be much more modest than in 2009 when the valuation starting point was much more attractive than it is today. As markets have run up sharply since early February, we would not be surprised to see a pullback or a few months consolidation before markets grind somewhat higher.

Emerging market stocks underperformed U.S. stocks in the first quarter and since November of last year have been in a consolidation phase after a huge surge in relative performance, mostly in the first half of 2009 (Chart 5). We expect this period of consolidation could last a while longer. A stronger recovery in emerging market economies has led to a rapid erosion of excess capacity and more upward pressure on inflation (although core inflation is still low). This has led to increased anticipation of monetary policy tightening, whereas policy tightening in the developed world is still viewed as something down the road. We believe that outperformance will resume when it becomes clear that healthy growth will continue even as tightening proceeds; however, we will be watching for any signs that indicate otherwise.

We recommend shifting to neutral exposure on EAFE markets (i.e. expressing our equity overweight through emerging markets and the United States). While EAFE markets are still attractively valued, the economic recovery in Europe and Japan is likely to continue lagging that of the United States. Earnings revisions also appear to be rolling over more decisively in EAFE markets than in the United States (Chart 6). Finally, while we do not believe the trade-weighted dollar has reached its long-term bottom, the current countercurrent rally could be more powerful than we initially expected.
Performance Summary, First-Quarter 2010

Even with choppy performance to start the year, the MSCI® World Index rose by more than 4% in the first quarter. Other risky assets also continued their advance, with U.S. High Yield bonds surging better than 4.5% and REITs ending the quarter with a total return of close to 9%. Commodities was one of the few areas that lagged in the quarter, falling more than 5%.

U.S. Equity Markets

Equity markets continued their climb in the first quarter, with the S&P 500 Index gaining 5.4%. The Russell 3000® returned close to 6%, and small caps, as measured by the Russell 2000®, jumped an impressive 8.9%, outpacing large caps. Three sectors posted double-digit returns, led by Industrials, which advanced over 13% in the period, followed by Financials (11.1%) and Consumer Discretionary (10.4%).

Non-U.S. Equity Markets

The MSCI® EAFE Index, in U.S. dollar terms, returned almost 1% in the quarter, and better than 4% in local currency terms. The MSCI® Emerging Markets Index, in U.S. dollar terms, gained 2.5%. While the dollar generally appreciated relative to developed market currencies, it moved in the opposite direction versus those of emerging markets, with the MSCI® Emerging Market Index returning only 1.4% in local currency terms.

Fixed-Income Markets

Following the lead of the equity markets, the riskier parts of the fixed-income universe, including high yield and emerging markets, had an impressive quarter, returning 4.6% and 3.6%, respectively. The broad U.S. investment-grade market, as measured by the Barclays Aggregate Index, also had a good quarter, generating a total return of 1.8%, led by corporate bonds, which moved ahead 2.3%.

Performance Summary as of:
3/31/2010

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<td>JPM EMBI+</td>
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*Formerly known as Lehman Brothers Aggregate Index
Please see page 5 for index definitions.
Explanation of Indexes

Citigroup (formerly Salomon Smith Barney) Non-U.S. World Government Bond Index. This Index is based on the Citigroup formerly Salomon Brothers) World Bond Index, and excludes issues denominated in U.S. dollars. The Index measures the total return of government securities in major sectors of the international bond market.

Dow Jones - AIG Commodity Index is a diversified benchmark for the commodity futures market. It is composed of futures contracts on 19 physical commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME).

Dow Jones Wilshire REIT Index. Measures U.S. publicly traded Real Estate Investment Trusts. The index is a subset of the Dow Jones Wilshire Real Estate Securities Index (WRESI). The indexes are weighted by both full market capitalization and float-adjusted market capitalization.


Barclays Capital Aggregate. Composed of U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities, and commercial mortgage-based securities.

Barclays US Corporate High Yield Index. Covers the universe of high-yield corporate bonds.

Barclays Capital US TIPS Index. An unmanaged index that represents securities that protect against adverse inflation and provide a minimum level of real return. To be included in this index, bonds must have cash flows linked to an inflation index, be sovereign issues denominated in U.S. currency, and have more than one year to maturity, and, as a portion of the index, total a minimum amount outstanding of $100 million U.S. dollars.

Morgan Stanley Capital International (MSCI®) Europe, Australasia, and Far East (EAFE) Equity Index. MSCI® EAFE acts as a benchmark for 24 developed-market stock portfolios. MSCI® Japan Equity Index is a subset of MSCI® EAFE.


MSCI World Index. A free-float weighted equity index that includes developed world markets but not emerging markets.

Russell 3000®, 2000®, & 1000®. The Russell 3000® is composed of 3,000 large U.S. companies representing approximately 98% of the U.S. equity market. The Russell 1000® represents the largest 1,000 companies in the Russell 3000®, and the Russell 2000® represents the 2,000 smallest companies. The indexes are value-weighted. The Russell indices are trademarks/service marks of the Russell Investments. Russell is a trademark of the Russell Investments.

S&P 500 Index. Covers 500 industrial, utility, transportation, and financial companies of the U.S. markets. The value-weighted index represents about 75% of the NYSE market capitalization and 30% of the NYSE issues.

Emerging market countries may have unstable governments and/or economies that are subject to sudden change. These changes may be magnified by the countries’ emergent financial markets, resulting in significant volatility to investments in these countries.

Investors cannot invest directly in an index.
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