



# INVESTMENT STRATEGY AND PORTFOLIO MANAGEMENT

July 2009

## Contents

Executive Summary.....	1
Economic Outlook.....	2
Market Outlook.....	3
Performance Summary.....	4

## Executive Summary

### Economic Outlook

- The economy is no longer in a freefall, but we should not assume that a normal economic recovery is underway.
- We expect that U.S. economic growth declined again in Q2, but at a much slower pace than in the previous two quarters.
- The most likely scenario, in our opinion, is for a weak economic upturn, notwithstanding the possibility of a quarter or two of strong growth in the second half of this year.
- The tremendous destruction of consumer wealth and the need to rebuild balance sheets likely will be a powerful constraint on growth in the U.S. and other countries.
- The median household in the U.S. will have lost nearly all of the equity in their mortgaged houses, and taken a 60-80% hit to net worth over the past few years, according to our estimates.
- Rising global unemployment rates and record high output gaps should keep the rate of inflation low, even in the face of near-zero policy rates and shocking deterioration in fiscal balances.

### Market Outlook & Investment Strategy

- Risk assets across the spectrum rose sharply over the past quarter, as investors breathed a sigh of relief on increased evidence the economy had avoided the worst-case scenario.
- After having experienced such a sharp relief rally, the outlook for risk assets for the balance of the year is neither terrible nor unambiguously bright, in our view.
- We believe the current environment is one where investors should stick close to policy guidelines and restrain from making big bets on investment strategy.
- Fixed-income risk assets remain an attractive area, in our view, but spreads have narrowed significantly over the past quarter and investors will need to be more selective.
- We would reduce overweight positions in high-yield bonds but maintain current exposure to investment-grade credit.
- Emerging market equities have outperformed strongly and are likely due for a period of consolidation. We would maintain our structural overweight, though, as fundamentals remains strong and valuations do not appear excessive relative to developed markets.

## Economic Outlook

The terrifying economic freefall that began late last year in the wake of the Lehman Brothers collapse has now passed and policymakers deserve enormous credit for steering the economy away from the abyss. After appearing chronically behind the curve for much of early part of the crisis, the policy response finally began to gain traction in March and has resulted in a significant and sudden improvement in financial market conditions (Chart 1). The improvement has yielded economic fruit as numerous signs of stabilization and so-called “green shoots” appeared on the economic landscape this past quarter.

There is much to celebrate in having avoided the worst-case scenario. However, it’s one thing to stop a freefall, and quite another to generate a sustainable, healthy economic recovery. One tracking model that we follow shows that U.S. economic growth still declined by 1.5% quarterly annualized in Q2. Given the continued structural problems of excess debt and constraints on credit, we believe the most likely scenario is still for a very weak economic upturn, notwithstanding the possibility of a quarter or two of strong growth in the second half of this year.

The tremendous destruction of consumer wealth and the need to rebuild balance sheets will be a powerful constraint on growth in the U.S. and many other countries. Recently released data from the Fed’s quarterly Flow of Funds report show that through March, household-sector net worth had fallen approximately 22% from its peak. This is by far the largest shock to the household-sector balance sheet since the inception of the data (Chart 2).

While the aggregate data are troubling enough, upon further analysis, we conclude that the picture is much worse for the median household. This is mainly because the “typical” American household buys housing (the largest asset on its balance sheet) on margin (i.e. with mortgage debt). We cover the details of our analysis in a separate paper, but by combining data from both the Fed’s Flow of Funds report and its triennial Survey of Consumer Finances (SCF), and making some reasonable assumptions on the path of house prices over the year, we come to the following conclusion: The median household has lost nearly all of the equity in their mortgaged houses, and taken a 60-80% hit to their overall net worth over the past few years.<sup>1</sup>

This loss of housing equity has profound economic implications. During the housing boom, it was easy to extract excess equity at attractive rates to buy cars and other goods, pay for education, or simply pay ordinary expenses. But if the equity of the typical homeowner is nearly gone, then this source of funding is gone even for those with jobs and good credit. Even if GDP growth resumes in late 2009 and 2010, this is likely to be a substantial headwind for several years.

Recently released economic forecasts contained in the June Economic Outlook from the Organisation for Economic Co-operation and Development (OECD) are consistent with our view of a slowing contraction in the major economies, followed by a weak recovery (Chart 3). Growth in the OECD area is expected to decline 4.1% in calendar 2009, and rebound a scant 0.7% in 2010. Given rising unemployment rates and a record output gap, inflation rates are expected to stay very low even in the face of near-zero policy rates and shocking deterioration of fiscal balances in the major economies.

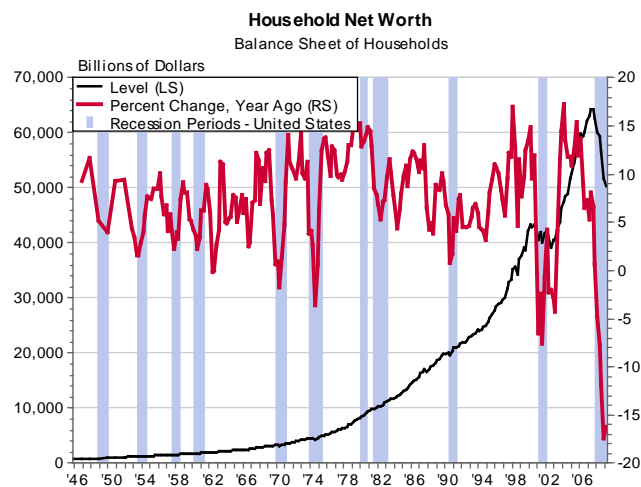
<sup>(1)</sup> *Fallout of the Great Recession*, by QMA managing director Ed Keon, June 2009

### Chart 1: Financial Conditions Have Returned To Pre-Lehman Levels



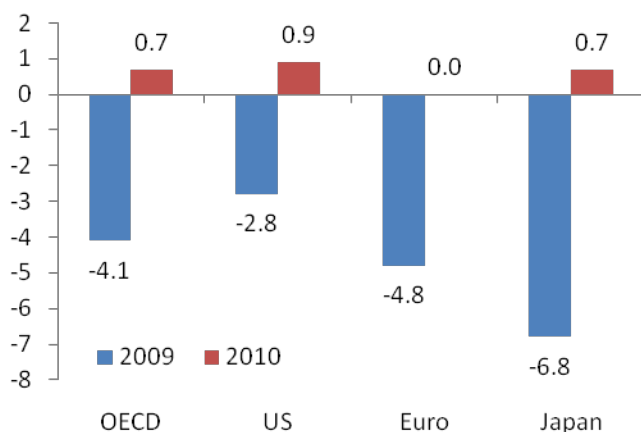
Source: Bloomberg

### Chart 2: Tremendous Destruction Of Consumer Wealth



Source: FactSet Research Systems

### Chart 3: OECD Economic Outlook Forecasts, June 2009



Source: OECD Economic Outlook

## Market Outlook & Investment Strategy

The rally in risk assets ran further than we expected over the past quarter. There was much to celebrate in having avoided the worst-case scenario on the economy, and investors spent much of the quarter doing so. Risk assets across the spectrum rose sharply, including equities, commodities, Real Estate Investment Trusts (REITs), and high yield bonds.

So after having experienced such a sharp relief rally, what is the outlook for risk assets over the balance of the year? Things look neither terrible nor unambiguously bright from here, in our view. The monetary and fiscal stance remains highly stimulative, and there is a record amount of cash on the sidelines, earning next to nothing in interest. Yet the outlook for the economy and profits remains highly uncertain, the credit environment remains constrained, and valuations across risks assets are no longer clearly cheap.

For example, U.S. stocks, after rising approximately 40% from the low reached on March 9, are back to average levels of valuation (Chart 4). Given the low hurdles represented by yields on cash and Treasuries, we think there's a good chance that equity markets will outperform these instruments over next six months. However, stocks face stiffer competition from fixed-income risk assets such as corporate bonds. This, combined with continued economic uncertainty, argues for a neutral weighting among stocks and bonds with a continued skew toward the riskier segments within fixed income.

Since December 2008, we have recommended overweight positions in fixed-income risk assets. High-yield bonds have been star performers so far this year (see next section). Investment-grade credit also posted impressive absolute returns for the quarter, while year-to-date returns have so far comfortably outpaced those of U.S. equities. But with outperformance has come significant spread compression, especially in the high yield sector (Chart 5)

While high-yield bond spreads are still comfortably above their long-term average, the peak in the default rate is likely to be significantly worse this time than in the previous two cycles. Thus, the current spread may not adequately compensate investors for the coming spike in default rates. We would take some gains off the table here, while still maintaining some exposure. As the narrowing in investment-grade credit spreads has been much less dramatic, we think there is more value here and would maintain exposure.

Our other key area of emphasis has been emerging market equities. Chart 6 shows the strong relative uptrend in these markets since October 2008. Is it time to cut back here as well? Given the strength of relative performance recently, a period of consolidation would not be surprising. We think the fundamentals still look positive, though, and valuation does not appear excessive relative to developed markets. The recently released OECD Economic Outlook echoed our previously expressed view that that the recovery in the emerging world is proceeding at a faster pace than in the OECD economies. Thus we prefer to ride out any near-term pullback that may occur over the next few months and stick with our overweight position.

Chart 4: Stocks Are Back To Average Valuations

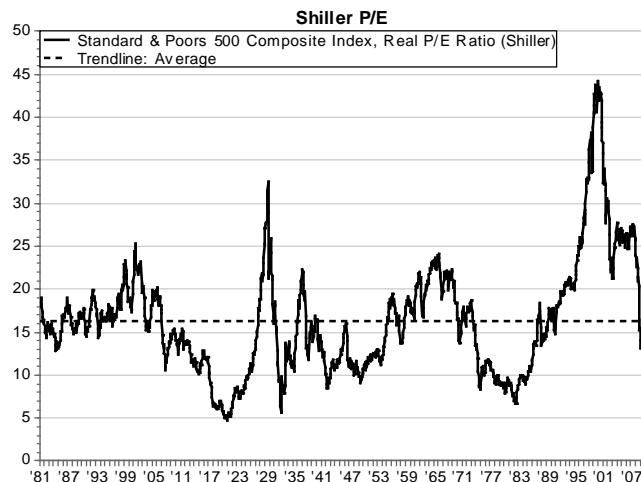


Chart 5: High Yield Spreads Narrow Significantly

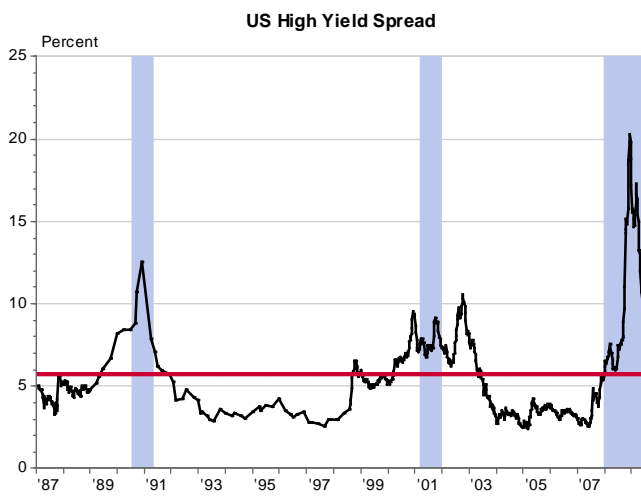
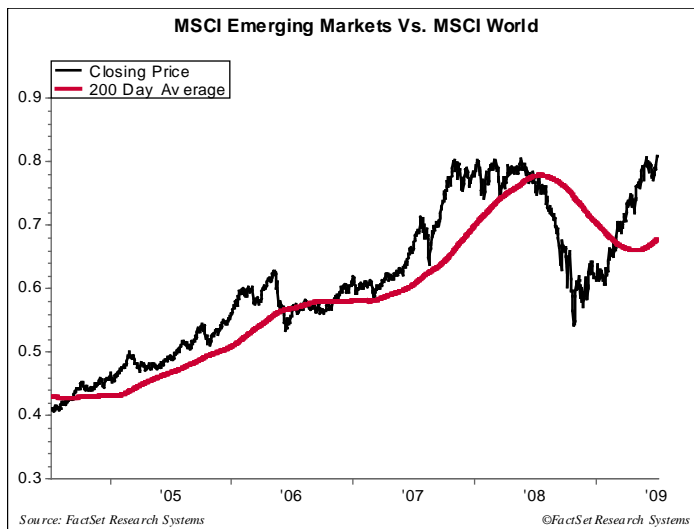


Chart 6: EM Equity Outperformance: Due for a Breather?



Source for charts 4-6: FactSet Research Systems

## Performance Summary, Second-Quarter 2009

Beginning in March, numerous economic indicators began to suggest that the worst of the economic crisis had been reached. In addition, first-quarter earnings reports came in better than expected for the first time in quite a while. As a result, a powerful global equity rally commenced, with the MSCI® World Index posting close to a 21% return in the second quarter. With optimism about an economic recovery in reach, oil moved up in concert with equities, breaching \$70/bbl during the quarter, helping the DJ AIG Commodities index to rise 11.7% in the period.

### U.S. Equity Markets

As evidence mounted that economic conditions and earnings may be stabilizing, U.S. equity markets rallied throughout the quarter. The Russell 3000® Index ended the quarter rising close to 17%, with the financial sector leading the charge with a 35% return as liquidity returned to many markets that were frozen not too long ago.

One of the most volatile areas of the market has been REITs. After posting terrible returns from the fourth quarter of 2008 through the first quarter of 2009, the DJ Wilshire REIT Index helped propel the rally with a 31.5% return in the second quarter. However, for the year, REITs are still down more than 13%.

### Non-U.S. Equity Markets

As leading economic indicators, on a global basis, appeared to have reached a trough, global equity markets rallied in the second quarter. Emerging markets lead the rally, with the MSCI® EM Equity Index rising over 35% in U.S. dollar terms for the quarter. With investors shedding safety, safe-haven dollars were sold, resulting in the dollar depreciating more than 5% versus the euro and over 2.6% versus the yen, benefiting unhedged U.S.-based investors. In the second quarter, in U.S. dollar terms, the MSCI® EAFE index rose 25%.

### Fixed-Income Markets

In the second quarter, Treasuries (-3.0%) lagged all spread sectors, especially high-yield bonds, with the Barclays U.S. Corporate High Yield Index generating a 23.1% return. The non-Treasury sectors of the U.S. Investment Grade bond market helped offset the negative performance of Treasuries, resulting in the Barclays Aggregate Index earning 1.8% for the second quarter.

With riskier assets being sought by investors, the dollar depreciated versus many currencies. This helped unhedged U.S.-based investors, with the Citi Non US Gov't (unhedged) index returning 5.4% compared with slightly positive performance for hedged investors.

## Performance Summary as of: 6/30/2009

	3 mo.	YTD	1 Year
<b>Equity</b>			
Russell 3000® Index	16.8	4.2	-26.6
Russell 1000® Index	16.5	4.3	-26.7
Russell 1000® Growth	16.3	11.5	-24.5
Russell 1000® Value	16.7	-2.9	-29.0
Russell 2000® Index	20.7	2.6	-25.0
Russell 2000® Growth	23.4	11.4	-24.8
Russell 2000® Value	18.0	-5.2	-25.2
MSCI® EAFE Index	25.4	8.0	-31.4
MSCI® EM Equity Index	34.7	36.0	-28.1
MSCI® World Index	20.7	6.4	-29.5
<b>Fixed Income</b>			
Barclays Capital Aggregate*	1.8	1.9	6.0
City BIG T-Bill (3 Mo)	0.1	0.1	1.0
Barclays High Yield*	23.1	30.4	-2.4
Barclays TIPS*	0.7	6.2	-1.1
Citi Non US Gov't (\$ hedged)	0.2	0.2	8.5
Citi Non US Gov't (unhedged)	5.4	-0.6	3.5
JPM EMBI+	10.0	12.7	2.4
<b>Other</b>			
DJ AIG Commodities	11.7	4.6	-47.1
S&P 500 Energy Sector	10.7	-2.1	-41.4
DJ Wilshire REIT	31.5	-13.1	-45.3

\*Formerly know as Lehman Brothers Aggregate Index

## 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.

JP Morgan Emerging Markets Bond Index Plus. The JP Morgan Emerging Markets Bond Index Plus is an market capitalization-weighted total return index of U.S. dollar and other external currency denominated Brady bonds, loans, eurobonds, and local market debt instruments traded in emerging markets.

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 Capital High Yield Index. Covers the universe of fixed-rate, non-investment-grade debt.

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.

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

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

Morgan Stanley Capital International (MSCI<sup>®</sup>) Emerging Markets Equity Index. MSCI<sup>®</sup> EM acts as a benchmark for 27 emerging-market stock portfolios.

MSCI<sup>®</sup> World Index. A free-float weighted equity index that includes developed world markets but not emerging markets.

Russell 3000<sup>®</sup>, 2000<sup>®</sup>, & 1000<sup>®</sup>. The Russell 3000<sup>®</sup> is composed of 3,000 large U.S. companies representing approximately 98% of the U.S. equity market. The Russell 1000<sup>®</sup> represents the largest 1,000 companies in the Russell 3000<sup>®</sup>, and the Russell 2000<sup>®</sup> 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.

Investors cannot invest directly in an index.

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