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2010 OUTLOOK
U.S. MARKET COMMENTARY

Awaiting Confirmation from Fundamentals

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The year 2010 will likely be a challenging one given the high expectations reflected in current market prices, uncertainties surrounding the economy and government policy, and the absence of clear signs of sustainable economic strength.

In this comment we briefly break down asset class performance (particularly that of equities) in 2009. We then provide our 2010 outlook and investment advice. By way of background, we have argued since late summer that the market rally was somewhat overdone.[1] From our perspective, the extraordinary strength and speed of the recovery had created valuations that required confirmation from fundamentals.

We presently regard U.S. equities as slightly overvalued, as they are priced for a stronger recovery than what we believe conditions and fundamentals warrant. Further, historical precedent has suggested that equities tend to bottom before the end of recessions and experience most of their recovery during the six-month period following the end of recessions.[2] This would suggest that the most powerful part of the rally has passed and additional multiple expansion will not be a likely source of return until fundamentals show a sustainable pick up. In fact, the pace of the rally in both equities and credit has slowed.

Nevertheless, given our view that other equity markets (and other asset classes) are over- or fully valued and our belief that policymakers will err on the side of providing continued liquidity, we conclude that investors should maintain roughly neutral allocations to U.S. equities. There are, of course, risks to our view, should any one of a number of potential scenarios ensue such as a double-dip recession or lower-than-expected GDP growth, deflation or high inflation, or uncertainty created by a disorderly withdrawal of the stimulus measures.

In short, we conclude that 2010 will likely be a challenging year given the strength of the rally since last March, the high expectations reflected in current market prices, and the uncertainties surrounding the economy and government policy.

2009: A Roller Coaster of a Ride

When 2008 ended, shell-shocked investors were left to contemplate the S&P 500's second-worst calendar year performance ever (-37%)[3] and terrible performance in virtually all other asset classes save nominal U.S. Treasuries. While equities and some credit instruments appeared to offer much more value than they had for a long time, investors still willing to bet on risk also had to consider both the deep recession into which the economy had fallen and the widespread fear engendered by America's worst financial crisis since the Great Depression.

Following the March 9 market trough, risk-seeking investors were rewarded handsomely. All told, 2009 performance was a mirror image of 2008 results (Exhibit 1). Treasuries, the sole U.S.

[1] Please see our August 2009 Asset Allocation in the Current Environment report *Now What?!*

[2] Please see our September 2009 Market Commentary *Living on Borrowed Time? Dissecting the Current Equity Market Rally*.

[3] The S&P 500 returned -43.9% in 1931.

asset class in the black for 2008, was the only performer in the red in 2009. Returns for most other asset classes were far above their long-term historical means.

The S&P 500 returned 26.5%, thanks entirely to multiple expansion (due to both the rise in equity prices and the sharp decline in earnings, particularly for financials) after price-earnings (P/E) ratios bottomed out on March 9. These returns were all the more impressive given Standard & Poor's estimate that dividend cuts totaled more than $52 billion (21.4% of their 2008 total).[4] Whereas dividend yields (supported by the sharp decline in equity prices) were 3.1% at the start of 2009 and increased to 3.4% in the first quarter, they had fallen by year-end to 1.9%, 1 standard deviation below their post-1955 historical average.

There were significant performance disparities among equities by size, style, and sector. Based on S&P 500 Index constituents, the rally in equities was broad based but led by smaller-cap and lower-quality stocks (typical of a market anticipating the end of a recession), although the most levered firms and those with the lowest returns on equity (ROE) posted *negative* returns in the year's last 15 weeks (Exhibit 2).[5] Among Russell indices, which include more smaller-cap stocks than are included in the relatively large-cap-oriented S&P 500, mid-cap stocks were by far the best performer, with the Russell Mid-Cap® Index returning 40.5%. This lifted performance of the Russell 1000® Index of mid to large caps (28.4%), which outperformed small caps by 126 basis points for the year.[6]

Growth stock returns were almost double those of value (with less of a differential in the mid-cap space), with the Russell 3000® Growth and Value indices returning 37.0% and 19.8%, respectively. Finally, all ten of the S&P 500's ten economic sectors were in the black for 2009, with information technology (61.7%), materials (48.6%), and consumer discretionary (41.6%) far outpacing all other sectors, and telecommunications (8.9%) and utilities (11.9%) lagging significantly.

On the credit front, high-yield and investment-grade bonds, which were pricing in Great Depression–like default rates when the year began, turned in excellent results. The former had easily their best year ever, with the Barclays Capital U.S. Corporate High Yield Index returning 58.2%. The Barclays Capital Corporate Investment Grade Bond Index returned 18.7%, its best showing since 1995 and its fifth-best performance since its 1973 inception. Moreover, investment-grade bonds outperformed equities on a risk-adjusted basis.

As for sovereigns, Treasuries returned -3.6%, their first annual loss since 1999 and worst performance since our data begin in 1973. Yields, which were near historic lows at the start of 2009, started rising even before March 9 as the government's extraordinary measures to backstop the financial system began to take hold. By year-end, yields on longer-term Treasuries had backed up to 14- to 17-month highs as investors' risk appetite returned and concerns about inflation grew. Treasury Inflation-Protected Securities (TIPS), by contrast, were a bargain at the start of the year given high yields that reflected expectations of more deflation than had ever

[4] As noted in our September 2009 Market Commentary *Dividends: Feeling the Pressure*, dividends have accounted for an average 32.2% of quarterly S&P 500 returns from 1965 to 2008 (and 39.1% of quarterly S&P 500 returns from 1900 through 2008).

[5] This covers the period from September 21, when we examined the drivers of the rally, through December 31, 2009. Please see our September 2009 Market Commentary *Living on Borrowed Time: Dissecting the Current Equity Market Rally*.

[6] Small caps are represented by the Russell 2000® Index.

been experienced in the United States. By year-end, TIPS were pricing in historically weak growth and more normal inflation expectations, resulting in a strong 11.4% return.

Notwithstanding the market's impressive rebound after early March, it is worth bearing in mind that S&P 500 returns were still a dismal -20.3% over the 2008–09 period, the ninth worst cumulative two-year performance ever. The Russell 2000® Index returned a slightly better -15.8%. By contrast, credit returns ranged from 8.8% (TIPS) to 16.8% (high yield) over the two years ended December 31, 2009 (Exhibit 1).

The Outlook for 2010

Although investors ended 2009 in much better shape than they began it, bargain hunting appears to be a much more difficult proposition as 2010 dawns than it was a year ago. In particular, equity prices discount extremely high 2010 earnings growth. As such, earnings are likely the key to whether the powerful post–March 9 rally can continue. The details underpinning earnings data, as opposed to just the headline numbers, will be crucial to evaluating its sustainability.

Not only will estimates be hard to meet, continued economic uncertainty raises the possibility of a substantial market *retreat*. The strength of the financial and housing sectors, which continue to confront significant structural problems, have especially important ramifications for capital markets. Another metric to keep an eye on is equity trading activity, which was generally *lower* in the second half of 2009 than in the first six months of the year. A return of volume would indicate higher liquidity and be a positive sign for equities.

Can Earnings Support Equity Prices?

In early March we viewed U.S. equities as fairly valued, but on the verge of undervalued. After hitting a 12-year low of 677 at the market close on March 9, the S&P 500 rose 64.8% through the end of 2009.[7] Thanks primarily to the sharp decline in reported earnings, which began in third quarter 2007 and climaxed in earnings of -$23.25 per share in fourth quarter 2008, the trailing P/E ratio of the S&P 500 was at record highs throughout 2009. The ratio declined to 22.0 by year-end, as fourth quarter 2008 earnings were dropped from the calculation.[8]

While the gyrations of the trailing P/E ratio in 2009 were extreme, they illustrate how this metric can be misleading at times of extremely high or low earnings. For this reason, we place much more stock in various measures that "normalize" earnings to account for cyclicality.[9] For example, on a trend-line basis, earnings ($49.00 per share) are actually back to trend (Exhibit 3), giving us the above-mentioned P/E ratio of 22.0. The ROE-adjusted P/E ratio (based on the MSCI U.S. Index),[10] meanwhile, is 15.6.

Our preferred standard is the Shiller P/E ratio, which normalizes P/E ratios by using real

[7] At year-end the S&P 500 remained 28.8% off its October 2007 peak.
[8] This is a provisional figure.
[9] Normalized P/E ratios attempt to adjust valuations for earnings cyclicality, by comparing both earnings and profitability (ROE) to some sort of normative measure over the earnings cycle. Real normalized P/E ratios (also known as Shiller P/E ratios) compare price levels to the ten-year average of real (inflation-adjusted) earnings per share (EPS), while ROE-adjusted P/Es adjust the current P/E multiple by the ratio of the current level of ROE compared to its historical norm. Trend-line P/E ratios compare current stock prices to the level of earnings predicted by long-term real earnings growth based on a simple linear regression.
[10] We use the MSCI U.S. Index to calculate ROE-adjusted P/E ratios for U.S. equities given that S&P does not publish timely book value data and that the MSCI U.S. Index allows us to make consistent comparisons with ROE-adjusted P/Es for global ex U.S. markets.

earnings over the previous ten years. Average real reported EPS from 2000 through 2009 were about $54 per share, making the P/E ratio 20.4 as of December 31, 2009 (Exhibit 4). This is about 0.6 standard deviation above the post-1881 historical mean of 16.3 (which would equate to a price level of 891) and about 58% greater than the 13.0 P/E ratio at the end of February 2009.[11] Given the significant expansion of multiples ahead of reasonable evidence that the earnings growth priced into the market will materialize, we now consider U.S. equities slightly overvalued, although certain segments of the market (high quality, growth, and mega-cap) remain fairly valued according to our analytics.

The question going forward is whether earnings growth will support the high expectations reflected in equity prices. With a market price of $1,115 (the S&P 500 price at year-end), earnings must be $74 per share in order for the trailing P/E to equal a fair value level of roughly 15. Analysts apparently believe this is achievable: as of late January, bottom-up consensus estimates are for operating EPS, which are estimated to have grown 15.1% (to $56.97 per share)[12] in 2009, to grow another 36.7% (to $77.86 per share) in 2010 (Exhibit 5) and 19.9% (to $93.37 per share) in 2011.

Thus, if the consensus is accurate, trailing four-quarter operating earnings will reach a new high (in nominal terms) 18 quarters after they last peaked in June 2007 ($91.47 per share). While this would match the period it took to recover the June 1989 peak reached prior to the 1991 recession, it would still be 50% longer than the average 12 quarters (22 quarters in real terms) for reported earnings to regain peaks lost during recessions from 1968 through 2002.[13]

As noted above, real reported earnings for the S&P 500 have returned to trend, but it is highly uncertain what level of earnings can be sustained going forward. Much of the run up in earnings in recent years was based on unprecedented levels of ROE largely driven by leverage that we do not expect to be as inexpensive or widely available for the foreseeable future. Downward pressure on earnings is also suggested by the fact that the decline in nonfinancials' EPS has been much smaller (30.3%) and shorter in duration than the 84.5% fall in financials' EPS over the last 27 months. Nonfinancials' EPS actually rose slightly in December after having fallen for the previous 12 months (Exhibit 6). Moreover, given that a rebound in financials off of weak earnings accounts for a lot of high earnings growth expectations, a scaling down of massive government support (explicit or implicit) could have a very negative impact on overall corporate earnings; financials accounted for 11.2% of corporate returns in 2009, the third highest of any sector (Exhibit 2).

The Case for a Strong Recovery

If history is any guide, the economic recovery will be strong. Since at least the early 1950s, real GDP has tended to increase the most following the deepest recessions. This has not been the case thus far. Although the 3.8% real decline in the 12 months ended June 2009 was the worst four-quarter number since our (quarterly) data begin in 1948, real GDP in the second half of 2009 grew at an annualized clip of just 3.9% (Exhibit 7). Still, the 5.6% annualized growth in the fourth quarter

[11] In our valuation work, we have found that the data from 1998 to 2000 skews the analysis unreasonably and therefore exclude it from our calculation of the mean and standard deviation. Using this method, the S&P 500's normalized real P/E ratio was 0.8 standard deviation above the historical mean of 15.8 at year-end.

[12] This January 29, 2010, consensus estimate from Morgan Stanley is higher than the 13.1% consensus estimate (as of December 18, 2009) reflected in Exhibit 6.

[13] Earnings peaked during the first three of the seven post-1968 recessions, but peaked prior to the start of the last four recessions.

was encouraging, in comparison with the muted 2.2% growth in the prior three months.

Growth is rebounding from significantly depressed levels and has been engineered through extensive stimulus and massive government intervention. Growth could also be spurred by an improving trade balance, consistent with the weakening of the dollar that has occurred in recent years (with the exception of the flight to the dollar that occurred in the fall of 2008); this would likely be a gradual process. In addition, growth could be spurred by an increase in capital expenditures. However, it is hard to rely on such possibilities without more evidence of a sustainable recovery. In addition, research by the International Monetary Fund (IMF) suggests that financial recessions tend to be sharper than nonfinancial recessions, with slower recoveries.[14] In short, surprisingly strong growth (i.e., better than that which is already priced into the markets) is possible but unlikely, and represents the key risk to our view.

It is worth noting that profits have been bolstered by significant cost cutting, which also does not seem sustainable. Gains in nonfarm business productivity, which grew at the fastest pace in six years during the second and third quarters, also are unlikely to be repeated (assuming that a reduction in labor costs was the primary driver). On the other hand, signs that innovation played a major role in enhanced productivity would be a strong positive signal. The reduction in labor costs also likely means downward pressure on consumer demand generally.

Still, recent data has encouraged investors. Whereas some took heart in mid-2009 from an apparent decrease in the rate of economic deterioration, economic data are now increasingly showing an uptick. For example, industrial production rose in each of the last six months of 2009 and is at its highest level in a year. While retail sales dipped slightly in December, they have increased 5.9% over the last year. Manufacturing inventories rose in October and November for the first time since August 2008 (although they fell slightly in December). However, retail sales, industrial production, and manufacturing inventories remain 7.8%, 10.8%, and 11.8% off their late 2007 peaks (Exhibits 8 through 10). Likewise, consumer confidence, as measured by the University of Michigan Consumer Sentiment Index, is basically at a two-year high (it is slightly lower than last October), but still 31 points off its (post-2000) January 2004 peak of 103.8.

On a seasonally adjusted annualized basis, sales of existing homes rose 7.4% in November, reaching their highest level since February 2007 (Exhibit 11), but then fell 16.7% in December, their largest monthly decline ever. However, sales were still up 15% from year-earlier levels and the year-over-year median sale price rose for the first time since August 2007. The S&P/Case-Shiller Composite 10 Index, meanwhile, which fell 33.5% from mid-2006 through April 2009, has since risen 5.6% (through October) (Exhibit 12).[15]

Unemployment, which began 2009 at 7.4%, may not have peaked, but its November decline to 10.0% from 10.1% was viewed by some as another positive sign.[16] High unemployment suggests firms face little pricing pressure and hiring is anemic. Until November, headline inflation had been negative (since March) for the first time since 1955, while core inflation has

[14] The IMF study covered recessions across the globe, not just in the United States.

[15] We use the S&P/Case-Shiller Composite 10 Index because we can also look at futures data for this index (see below). However, the broader S&P/Case-Shiller Composite 20 Index experienced a similar decline, falling 32.5% from July 2006 through April 2009.

[16] The rate was unchanged in December, but 85,000 jobs were lost.

remained in the 1.5% to 2.0% range for more than a year (Exhibit 13). Significantly, inflation expectations remain muted (Exhibit 14).

Cause for Concern

Moving from the low point of a recession to sustained economic growth takes time, and the evidence of recovery at this juncture is incomplete and subject to interpretation.

Jobs and Sales. One issue is whether this will be a "jobless recovery." Despite the huge rally in equity markets since March 9, more than 3.3 million nonfarming jobs were lost during the last ten months of the year.[17] The unemployment rate remains higher than at any time since 1950 (when our data begin), other than a ten-month stretch during 1982–83 (when it peaked at 10.8%), and the number of hours worked per week continues to decline. Economists are also focusing increasingly on the U-6 rate, now 17.3% (and rising), which includes underemployed workers. The gap between this rate and the traditional (U-3) measure has reached historic highs (Exhibit 15).

Given the importance of consumption to the U.S. economy, a *sustained* economic recovery will not occur until significant numbers of people are able to go back to work. To be sure, a recovery in employment always lags economic recovery in the United States. Still, it is worth noting both that the number of people employed is now back to 2000 levels and that a couple of hundred thousand jobs normally need to be created each month just to hold unemployment constant. Bridgewater Associates believes that the unemployment rate will not decline meaningfully in the absence of sustained growth of more than 3%. Meanwhile, substantial job creation would increase the likelihood of the Federal Reserve Board (Fed) tightening (which could be in the form of interest rate increases and/or a reversal of quantitative easing measures) or at least expectations of Fed tightening, which could, as in the past, negatively impact capital markets.

Even if a substantial number of new jobs are created, consumer demand will lag if consumers continue to save at the highest rate in 11 years, albeit one well under the post-1958 average of 7.0% (Exhibit 16). There is no doubt that overborrowing contributed mightily to the economic house of cards that was built last decade, but the necessary deleveraging of American households (whose debt remains at high historical levels despite a recent decline) creates its own set of problems in a moribund economy.[18] Of course, low interest rates may constrain a much larger increase in the savings rate. The key question (for which we have no answer) is whether the deleveraging will take hold now or later. It is certainly possible that growth could be sustained in the shorter term—possibly even with an *increase* in leverage—before the extreme deleveraging phase occurs.

It is important to bear in mind that small businesses, which produced half of private, nonfarm U.S. GDP from 1998 to 2004 and account for 65% of all new jobs created over the last 15 years, continue to struggle—another indication that a broad-based recovery is not underway. Seasonally adjusted earnings for small businesses are only slightly improved from record lows (going back to 1986) reached earlier this year. The National Federation of Independent Business (NFIB) reports that optimism among small businesses is declining once again (the

[17] This is nearly as much as the total number of jobs lost during the 1981–82 recession, the previous worst from an unemployment perspective since World War II. Some 8.4 million jobs have been lost since January 2008.

[18] Indeed, David Rosenberg of Gluskin Sheff estimates that even cutting the total nominal debt to GDP ratio from 369% (its current level) to 2002 levels of around 300%, which is well above the post-1952 historical average, would take nearly $10 trillion out of the economy.

second-worst reading in the NFIB's optimism index's 35-year history was reached in March 2009), which is reflected in declining employment, record low capital spending, and low inventories. Most small businesses report declining sales and earnings. Significantly, far more small businesses cite poor sales and taxes as their primary concerns, as opposed to financing.

Have Problems in the Financial and Housing Sectors Been Resolved? We have harped for some time on the fact that it was vital to address problems in the financial and housing sectors.[19] Despite some progress, these issues have still not been rectified. True, almost all institutions with assets of $100 billion or more are now considered well capitalized by the government in the wake of last spring's so-called "stress tests" (and the subsequent capital-raising efforts of certain of the examined institutions). However, large banks have relied on government support (e.g., as a source of cheap and ready funding and as a backstop for the issuance of senior unsecured debt) while smaller banks continue to struggle in a difficult environment. In 2009 140 banks failed, the highest number since 1990, and 552 banks are on the FDIC's watch list. The chairman of the FDIC testified in October that she expects "the numbers of problem institutions to increase and bank failures to remain high for the next several quarters."

Despite the government's massive efforts to promote liquidity and provide credit, and the jawboning of bank executives, lending continues to decline. Commercial bank loans, which grew at an annualized compound rate of 9.2% from 1947 through October 2008, fell 5.3% in the subsequent 12 months, its sharpest contraction since our data begin in 1947 (Exhibit 17). The decline was particularly severe for commercial and industrial loans, the outstanding balance of which dropped 16.5% (on a seasonally adjusted basis) from November 2008 through November 2009. Commercial paper issuance by nonfinancial issuers is down 50.7% on a seasonally adjusted basis.

The housing sector is even more problematic, notwithstanding the positive signs discussed earlier. The massive number of foreclosure sales has helped drive sales of existing homes[20] and foreclosure levels as a percentage of both prime and subprime loans continue to rise, as do the percentage of households (now 25%) that are underwater. Housing starts and new home sales have been boosted by artificially low mortgage rates and various federal programs and remain far below their peaks (Exhibit 18), with residential construction spending back to 1996 levels. As of December 31, the futures market was pricing in a 5.4% drop in housing prices by November 30, 2011 (Exhibit 12).

In the fall of 2009, the Treasury, Fed, Federal Housing Administration (FHA), FDIC, and Congress all extended or created housing subsidy programs to support the residential real estate market.[21] The government's massive intervention, which includes the extension (and broadening) of the homebuyer tax credit, loan modification programs, and a vast expansion of the role of the Government National Mortgage Association (GNMA), reflects its concern that the sector is not presently strong enough to rebound on its own and its fear that widespread foreclosures will devastate the value of other homes, with much larger secondary effects.

Many believe the $3.5 trillion in commercial real estate loans may be the next shoe to drop, with

[19] Please see our December 2007 Market Commentary *The Dénouement Begins*.

[20] In 2009 40% of home sales were foreclosures or short sales.

[21] Tax-related measures were also taken to support commercial real estate.

more than $1 trillion of debt maturing from 2010 through 2012. Concern centers on borrowers' potential inability to refinance, given the tightened credit conditions and the sharp drop in prices that has already occurred (which has driven up the loan to value ratio on properties). The Moodys/REAL Commercial Property Price Index, which tracks national property, is down 43.7% from its October 2007 peak. About half of outstanding commercial real estate loans are owned by banks. Two-thirds of these are held by regional banks, according to Bridgewater Associates, which has estimated losses of about $700 billion on all commercial real estate loans.

Government Policy: Help or Hindrance?
Massive and unorthodox government actions in late 2008 and in 2009 appear to have stabilized a financial system that many saw as being in danger of imminent collapse in the months following the September 2008 Lehman Brothers bankruptcy. On the economic front, however, it is far from clear that government policy will, in the end, be seen as having promoted growth over the medium- or long-term, though it may have moderated the extent of the downturn.[22] Many government measures to support sectors such as housing and autos are likely to reduce future growth, as they have accelerated spending that would have occurred later.

Will banks, particularly those which have what appears to be an implicit federal guarantee due to their "systemic" importance, end up engaging again in highly risky behavior harmful to the system? Likewise, will support to the housing industry lead to the same problems fueled by easy home loans in recent years? GNMA now provides over half of the mortgages for new home purchases—and these mortgages have an average loan-to-value ratio of about 95%. It has guaranteed and is monitoring more than $825 billion in FHA home loans—and the roughly 300 firms approved to issue GNMA-backed securities—with just over *60* employees.[23]

The Obama administration's continuing concerns about the economy are clear from its decision to extend the Troubled Asset Relief Program (TARP) through October 2010, its planned use of repaid TARP money to, in effect, fund a second stimulus plan (aimed in large part at small businesses), and its decision to convene a jobs summit in December. At the dawn of 2010, it is still unclear whether the economy can grow in the absence of stimulus. Analysis of third quarter growth, for example, shows that it was entirely due to government programs such as cash for clunkers and a tax credit for first-time homebuyers.

Other policy-related questions also bedevil the market. What will happen when quantitative easing and other extraordinary government measures are wound down?[24] Clearly, risks will rise but the market impact is unclear. Will the government's huge borrowing needs force interest rates higher (as may already be starting to occur)? If so, will central banks resume quantative easing measures to purchase sovereign debt again? This would clearly be negative for the currencies, but may help support economic growth. However, U.S. policy rate increases ahead of other central banks would likely firm up the U.S. dollar and hit exporters that have benefited from the greenback's decline this year. Business

[22] For a much fuller discussion of this and some of the other points in this section, please see our August 2009 Market Commentary *Uncharted Waters: The U.S. Policy Response to the Financial and Economic Crisis*.

[23] The number of employees is little changed from previous years despite the increase in GNMA activities.

[24] Please see our August 2009 Market Commentary *Uncharted Waters: The U.S. Policy Response to the Financial and Economic Crisis* for an extended discussion of these measures and our 2010 Outlook Global Market Commentary *Lower Leverage and Fading Stimulus Present Opportunities and Risk* for a broader discussion of the global importance of this issue today.

planning has been hampered by uncertainty about tax rates and the costs associated with possible health and/or cap- and trade-related legislation (or regulations). Legislation that would massively overhaul regulation of the financial industry (the House passed one bill in December) could also impact the economy for years to come.

Investment Conclusions

Just as the market's dramatic decline in 2008 and the dislocations that ensued in the wake of the Lehman Brothers' bankruptcy created substantial opportunities for investors,[25] 2009's sharp rebound has put investors in a quandary, with all major U.S. asset classes in the overvalued or fairly valued categories. As far as equities go, investors should also bear in mind not only that price returns tend to be concentrated in the first six months following the market trough, but also the extraordinary pace of the post–March 9 rally: from 1926 through 2008 it has taken the market 39 months, on average, to regain market losses from significant market troughs to the degree experienced between March 9, 2009, and the end of the year (Exhibit 19).[26] Hitting earnings expectations will be even more important than usual for equities given the expansion in multiples that has already occurred in anticipation of a strong rebound in earnings and the fact that dividend increases may not provide much support; Standard & Poor's expects a 6.1% increase in dividends for the S&P 500 in 2010, only slightly more than the historical 5.6% dividend growth rate. Cash-rich companies are a more likely support for equities, although it remains unclear what would convince companies that were reluctant buyers in 2009 (stock buybacks by S&P 500 firms in nominal terms are estimated to have been at or near post-1998 lows) to buy at substantially higher prices today. A pickup in merger & acquisition activity is perhaps more of a potential tailwind given near-record levels of cash on corporate balance sheets and the muted deal activity we have seen thus far in the United States and globally.

Given both relative valuations and our aforementioned concern regarding economic fundamentals, we continue to see more opportunity in 2010 in large-cap (particularly mega-cap) and growth stocks than in their small-cap and value counterparts. This is consistent with our advice to overweight high-quality assets within equities. However, data pointing to a sustainable, private sector–led recovery, such as a stronger-than-expected pickup in employment (which, as noted earlier, is a lagging indicator), healthy top line growth in revenues as opposed to just profits, and more signs of structural improvement in the financial and housing sectors, would quell concerns about a "double-dip recession" and suggest much greater opportunity in small caps (as a beta play on economic growth) and value stocks than exists at present.

As for other asset classes, the compelling proposition offered by bonds (other than nominal Treasuries) a year ago is long gone. Investment-grade bonds still offer reasonable compensation for risk, but no longer appear attractive given the likely opportunity cost relative to equities, particularly if economic growth surprises to the upside. This is even more the case with respect to high-yield bonds and bank loans, which we view as attractive only when they are clearly undervalued; however, there may well be further opportunities in distressed investments in 2010 should the economy stumble once again or other shoes (e.g., commercial real estate) drop. Investors should remain prepared for distressed opportunities in general and take advantage of

[25] We discussed this in our December 2008 Market Commentary *Who Will Be First Out of the Bunker?* and in various other publications.

[26] A significant market trough is defined as a downturn of approximately 20% of more from a new market peak.

any future valuation disparities that are likely to develop should the market exhibit volatility in the face of high expectations and economic uncertainty.

Finally, for investors that can realistically handle illiquidity, we continue to advocate selective opportunities in private equity and venture capital, but only through the very best managers. Conditions are gradually improving for investments in these asset classes. With purchase and leverage multiples now reasonable after having been highly stretched for several years and pre-money valuations moderating, we regard these investment strategies as reasonably valued, but clearly challenging.[27] There may yet be opportunities in the secondaries market.

Even should economic growth and corporate earnings be stronger than expected, it remains unclear whether the investor of 2010 (the individual investor in particular) is the same risk-seeking creature we have seen in recent years. It has been at least two years, after all, since equity funds have seen net inflows. In 2008, risk-averse and liquidity-driven investors fled equity funds and piled into money market funds, although bond funds also saw a small inflow. In 2009, much of the money came out of money market funds, but it went almost entirely into bond funds; equity funds still saw a net outflow for the year (through November) (Exhibit 20). While such fund flows have thus far been an indicator more of sentiment than of returns—equities, after all, rallied much more than investment-grade bonds after March 9—they do suggest potential constraints on equity prices going forward. Relatively low yields on Treasuries and TIPS are another indication that investor mentality may have shifted while the surge in gold, which is also attracting a lot of manager interest, and other commodities are another such indication (Exhibit 21).

After March 9, 2009, a rising tide lifted all risk-asset boats within months to heights anticipated by few investors in the early part of the year. However, the market is likely to differentiate more among asset classes in 2010, barring a return of a crisis mentality. All told, 2010 is likely to be a difficult year for investors, with outsized returns unlikely unless there are clear signs that the private sector is growing rapidly and that such growth is sustainable. Investors will need to parse earnings data carefully and keep an eye on policy questions such as when the Fed is likely to raise rates (the market usually cools down in the year following rate hikes), how the Fed shrinks its balance sheet, how the government addresses the deficit, and the level of the government's intervention in the economy. Moreover, even if we do not experience high inflation, asset bubbles are like to result (though not necessarily in 2010) from the amount of money that has been created by the U.S. and other central banks, making caution and rebalancing especially important.

[27] For more details concerning our views on private equity and venture capital, please see our 2010 Outlook Global Market Commentary *Lower Leverage and Fading Stimulus Present Opportunities and Risk*.

The U.S. government pursued extraordinary fiscal and monetary measures in 2009 to combat the recession and the related financial crisis. These measures included a $787 billion stimulus package, oversight of the $700 billion Troubled Asset Relief Program (TARP) (which was passed in late 2008), and the Federal Reserve Board's (Fed) assumption of trillions of dollars in potential liabilities as part of its efforts to provide liquidity and shore up credit creation. By the end of the year, the Fed had scaled back its efforts significantly, reflecting vastly improved credit conditions. On the fiscal front, however, notwithstanding the repayment by TARP recipients of some $165 billion of the $245 billion they received,[1] the government remained just as involved as it was in the early part of the year.

Despite a 7.3% contraction (on an annualized basis) in the first half of the year (Exhibit 7), real GDP grew 0.1% in 2009, as the U.S. economy narrowly avoided its first calendar-year decline since 1991.[2] Although some observers are skeptical that the recession is really over, it appears that the National Bureau of Economic Research (NBER) will eventually determine that it ended some time in the second half of the year.[3] According to the head of the NBER committee responsible for dating the business cycle, output probably bottomed during the summer while unemployment, the other criteria, may have reached a trough at the end of the year.

[1] This figure apparently does not include dividends or interest paid by TARP recipients to the government.
[2] Since 1929, there have been 17 years of negative real growth.
[3] It usually takes NBER six to 18 months to confirm the start or end of a recession.

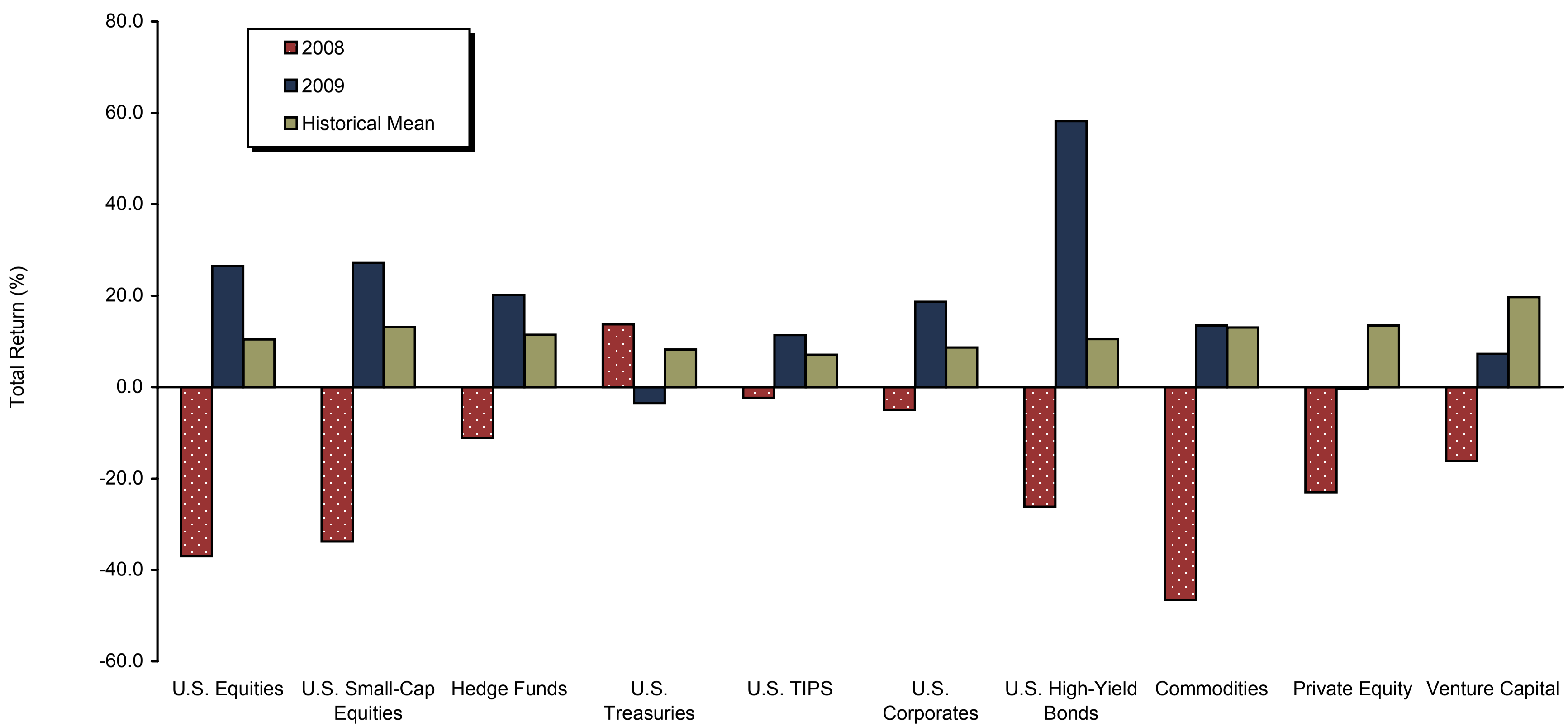
From an equity perspective, this recession is most similar to the downturn experienced in the early 1930s (for this reason, some consider it an actual depression). If it is deemed to have officially ended in July (the unofficial consensus as of this writing), at 19 months it would constitute the longest post-1926 downturn apart from the 42-month decline from 1929 to 1933 (Exhibit 22); recessions from 1926 to 2001 averaged 13 months. Likewise, the 31% drop in the normalized real price-earnings (P/E) ratio would be second only to the 77.6% drop experienced at the start of the Great Depression. The record 86.1% decline in earnings per share, however, would best the 72.8% drop experienced from 1929 to 1933. Still, the S&P 500's 32.7% price decline, while the second highest since 1928, is far less than the 81.6% fall experienced during the three-and-a-half years of the Great Depression and actually closer to the average 4.4% drop during recessions (the median is actually a *positive* 5.4%).[4]

[4] Given the ongoing market rally, the declines in the normalized P/E ratio, earnings, and prices are smaller if the end of the recession is dated later than July. However, these declines remain extremely high on a historical basis. It should also be noted that since markets try to anticipate the economy, the performance of equities during a recession understates the full magnitude of the decline; indeed, in seven of the 13 recessions from 1929 to 2001, equity returns were *positive*.

Exhibit 1

Comparative Performance of Various Capital Markets

2008–09



	U.S. Equities	U.S. Small-Cap Equities	Hedge Funds	U.S. Treasuries	U.S. TIPS	U.S. Corporates	U.S. High-Yield Bonds	Commodities	Private Equity	Venture Capital
2009 return (%)	26.5	27.2	20.2	-3.6	11.4	18.7	58.2	13.5	-0.4	7.3
2008–09 return (%)	-20.3	-15.8	6.9	9.7	8.8	12.8	16.8	-39.3	-23.3	-10.0

Sources: Barclays Capital, BofA Merrill Lynch, Cambridge Associates LLC, Eurekahedge PTE LTD, Federal Reserve, Frank Russell Company, Standard & Poor's, and Thomson Datastream.

Notes: U.S. venture capital and private equity data are through September 30, 2009. Data history for mean and median calculations varies by asset class. For example, data for the S&P 500 starts in 1881, while data for the ABN Eurekahedge Index starts in 2000.

Exhibit 2

S&P 500 Performance

2009

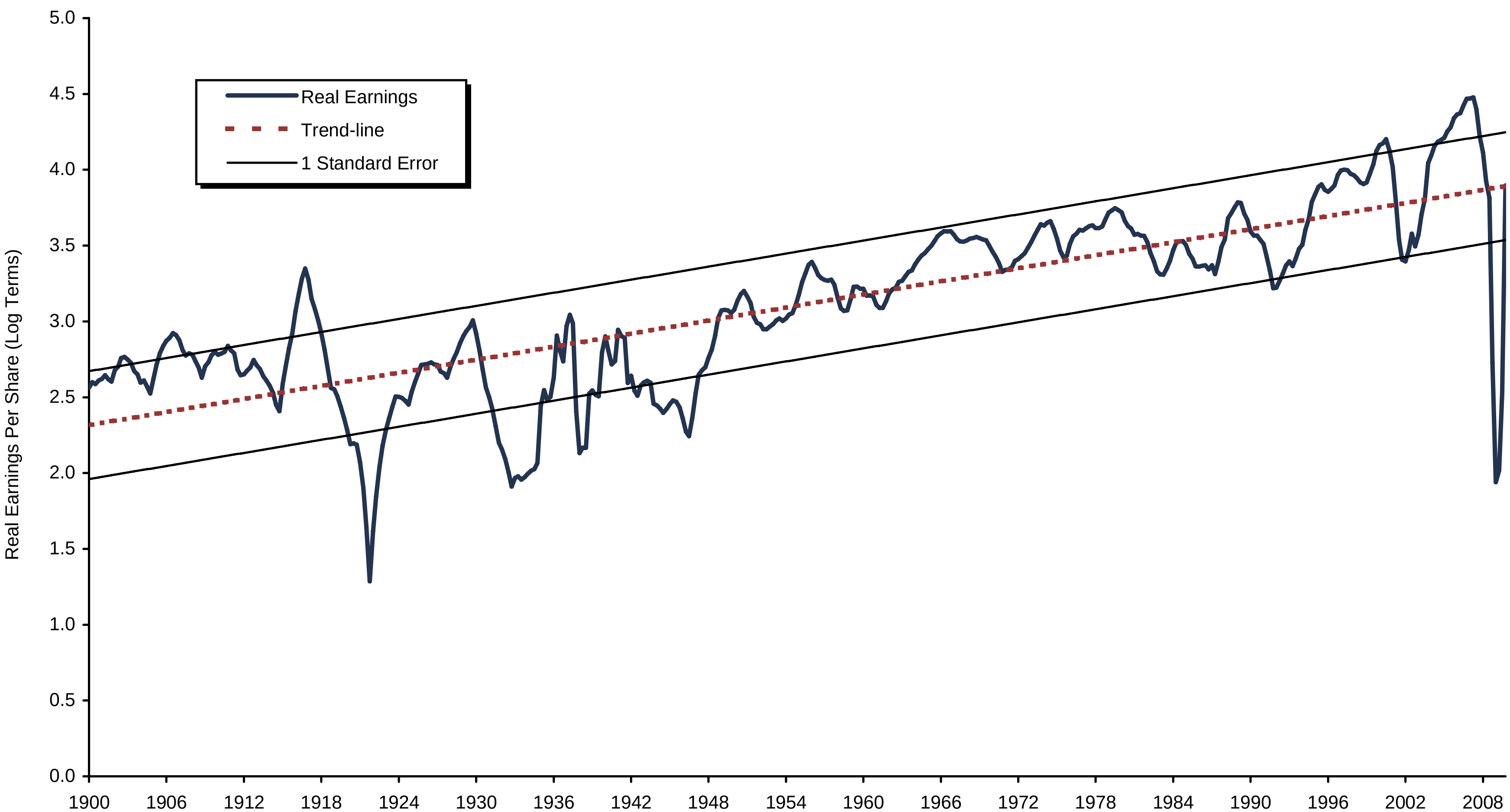
Sector	Jan 1 – Mar 9 Return	Jan 1 – Mar 9 Contribution	Mar 10 – Sep 21 Return	Mar 10 – Sep 21 Contribution	Sep 22 – Dec 31 Return	Sep 22 – Dec 31 Contribution	Jan 1 – Dec 31 Return	Jan 1 – Dec 31 Contribution
Consumer Discretionary	-25.4	-2.1	75.3	6.3	8.2	0.8	41.6	3.8
Consumer Staples	-18.7	-2.3	33.8	4.6	5.5	0.7	14.9	1.6
Energy	-19.1	-2.5	35.1	4.9	4.1	0.5	13.8	1.5
Financials	-50.0	-6.2	143.4	13.3	-3.7	-0.6	17.2	3.0
Health Care	-17.7	-2.8	34.6	5.4	8.1	1.0	19.7	2.0
Industrials	-35.2	-3.9	80.7	7.4	3.3	0.3	20.9	1.6
Information Technology	-13.6	-2.4	69.3	12.2	10.6	2.0	61.7	10.8
Materials	-20.1	-0.6	77.3	2.4	4.9	0.2	48.6	1.6
Telecommunication Services	-20.0	-0.7	25.5	1.2	8.6	0.3	8.9	0.3
Utilities	-22.3	-1.0	35.2	1.6	6.5	0.2	11.9	0.2
Index Return		**-24.6**		**59.3**		**5.3**		**26.5**
Market Cap Quintiles								
Q1 (Largest)	-24.9	-17.0	50.4	35.4	5.2	3.5	20.6	13.4
Q2	-21.4	-3.5	64.3	10.1	5.6	0.9	37.1	6.3
Q3	-25.2	-2.1	81.6	6.3	5.0	0.4	35.2	2.7
Q4	-28.8	-1.4	91.4	4.2	5.7	0.3	40.7	2.1
Q5 (Smallest)	-26.7	-0.6	168.9	3.1	6.2	0.2	71.1	1.7
Forward P/E Quintiles								
Q1 (Cheapest)	-26.7	-5.2	45.8	11.7	3.7	0.8	20.8	3.5
Q2	-18.9	-5.2	40.7	10.9	6.1	1.4	12.8	2.7
Q3	-23.1	-5.2	62.5	11.6	7.9	1.6	32.0	6.8
Q4	-32.3	-5.2	82.4	12.2	4.4	0.7	28.4	5.2
Q5 (Most Expensive)	-19.9	-2.2	79.6	9.2	8.9	1.2	59.9	7.4
Nonearners	-41.2	-1.6	116.1	3.7	-10.0	-0.5	14.5	0.9
ROE Quintiles								
Q1 (Highest)	-18.8	-5.1	42.4	12.1	7.3	1.9	23.6	6.0
Q2	-16.3	-3.3	48.0	10.4	8.9	1.6	34.5	6.8
Q3	-29.8	-5.1	65.4	10.6	5.9	1.0	21.2	3.1
Q4	-21.2	-3.3	47.7	7.3	5.8	0.7	25.7	4.0
Q5 (Lowest)	-40.4	-4.9	114.5	11.6	-1.6	-0.3	26.5	4.0
NA	-33.9	-3.1	89.2	7.2	3.6	0.4	29.2	2.6
Leverage								
Q1 (Highest)	-42.2	-7.8	121.9	16.2	-2.5	-0.5	20.6	4.5
Q2	-23.7	-3.2	51.5	7.6	6.3	0.9	23.7	2.8
Q3	-22.7	-4.1	54.7	10.2	7.8	1.3	28.6	4.9
Q4	-19.9	-6.4	41.6	14.1	8.0	2.4	23.0	6.3
Q5 (Lowest)	-16.1	-2.7	58.0	10.1	6.1	1.0	39.0	7.2
NA	-21.3	-0.3	56.9	1.0	10.4	0.2	47.4	0.7

Sources: FactSet Research Systems and Standard & Poor's.
Notes: NA indicates data were not available or the companies were not in the index for the entire period. Nonearners include companies that reported less than $0.10 earnings per share or negative earnings. Leverage is defined as total assets divided by stockholder equity.

Exhibit 3

S&P 500 Real Earnings

March 31, 1900 – December 31, 2009



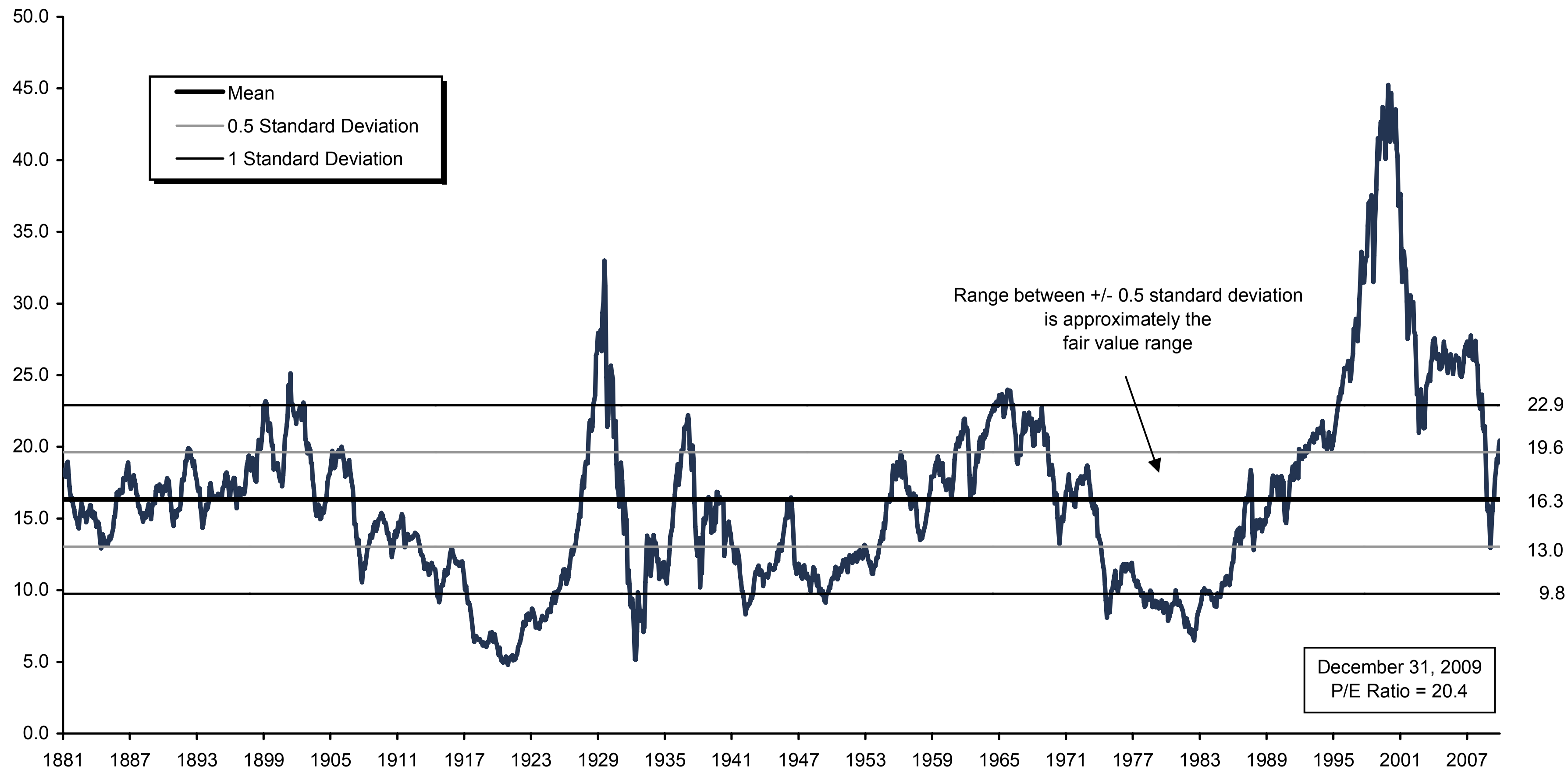
Sources: Robert J. Shiller, Standard & Poor's, and U.S. Department of Labor - Bureau of Labor Statistics.

Notes: Data are shown in logarithmic terms. Real earnings are adjusted to December 31 dollars. Trend-line based on simple linear regression trend model. Data are quarterly.

Exhibit 4

S&P 500 Normalized Real Price-Earnings Ratios

1881–2009

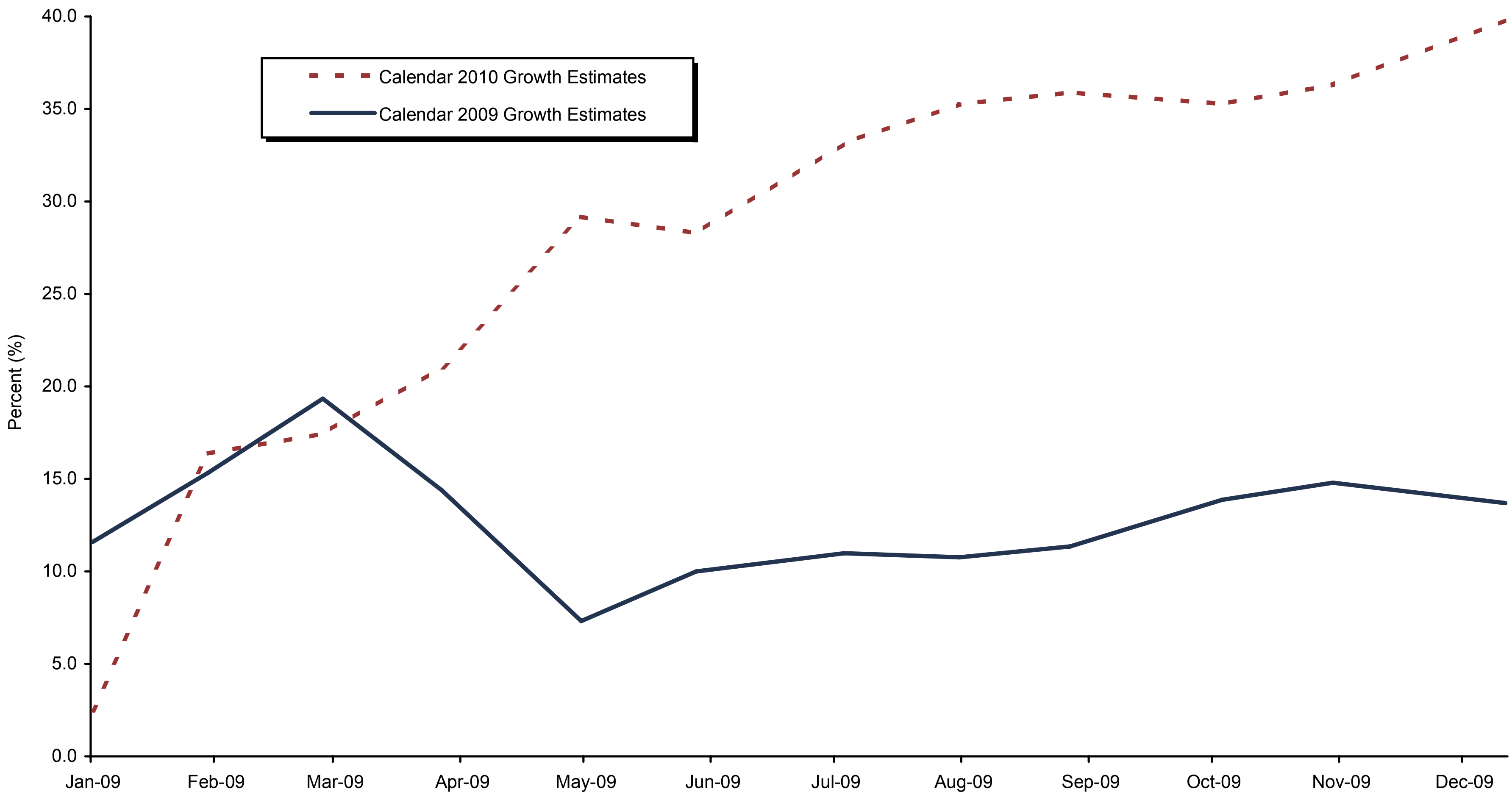


Sources: Robert J. Shiller, Standard & Poor's, and Thomson Datastream.
Notes: Graph is based on monthly data. Normalized real price-earnings (P/E) ratios (Shiller P/E ratio) for the S&P 500 are calculated by dividing the current index price by the rolling ten-year average of inflation-adjusted earnings. Monthly earnings are interpolated from actual quarterly reported earnings per share. Real earnings are deflated in terms of December 31, 2009 dollars. Historical data before 1936 are provided by Professor Robert Shiller.

Exhibit 5

Analysts' Changing Consensus Operatings Earnings Per Share Growth Expectations for the S&P 500

2009–10

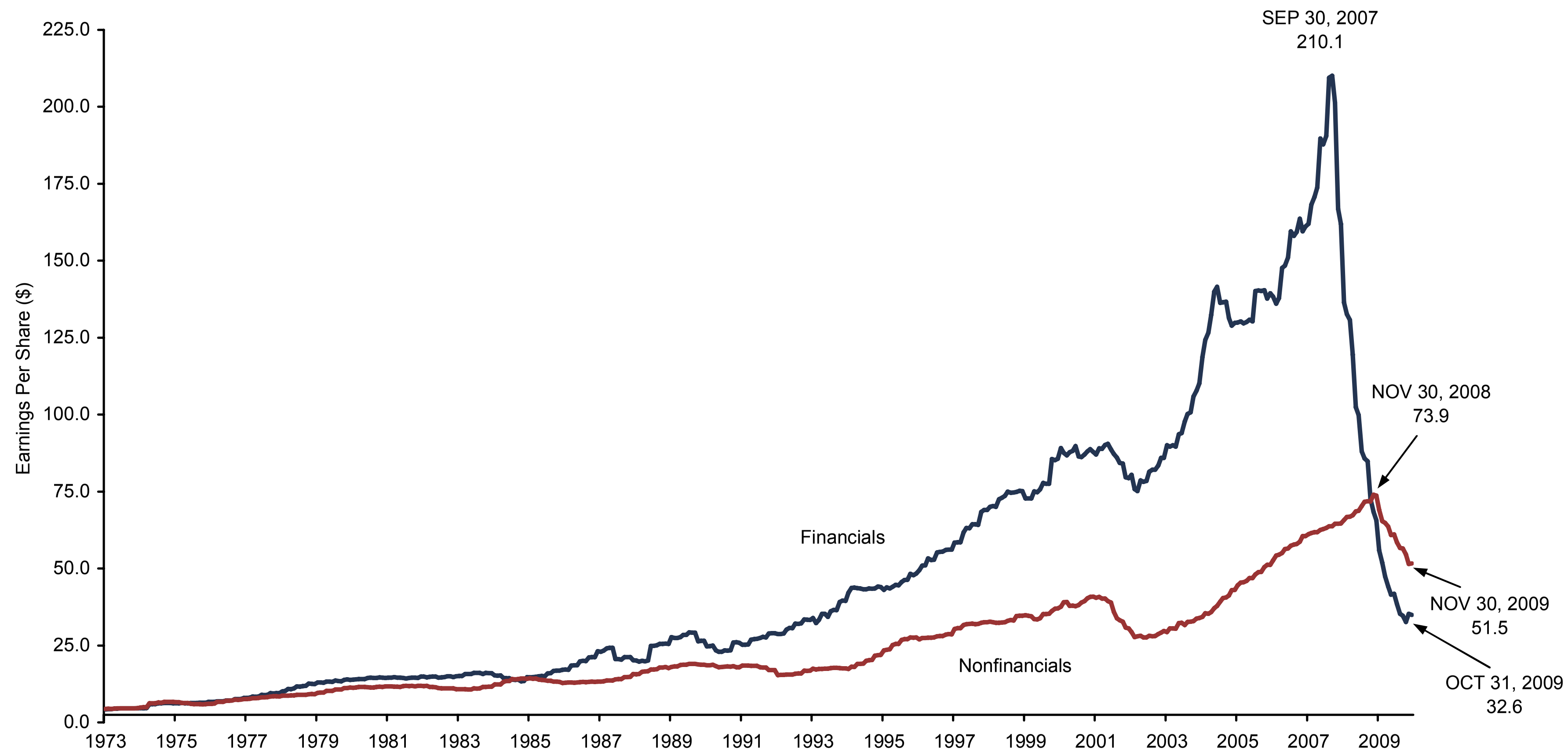


Sources: FactSet Research Systems, Morgan Stanley Research, and Thomson Financial.
Notes: Growth expectations are based on month-end, or near month-end, consensus estimates. Data are bottom-up estimates of year-over-year growth in operating earnings, on a calendar year basis. Data are as of January 8, 2010.

Exhibit 6

Datastream United States Index Earnings Per Share

January 31, 1973 – December 31, 2009



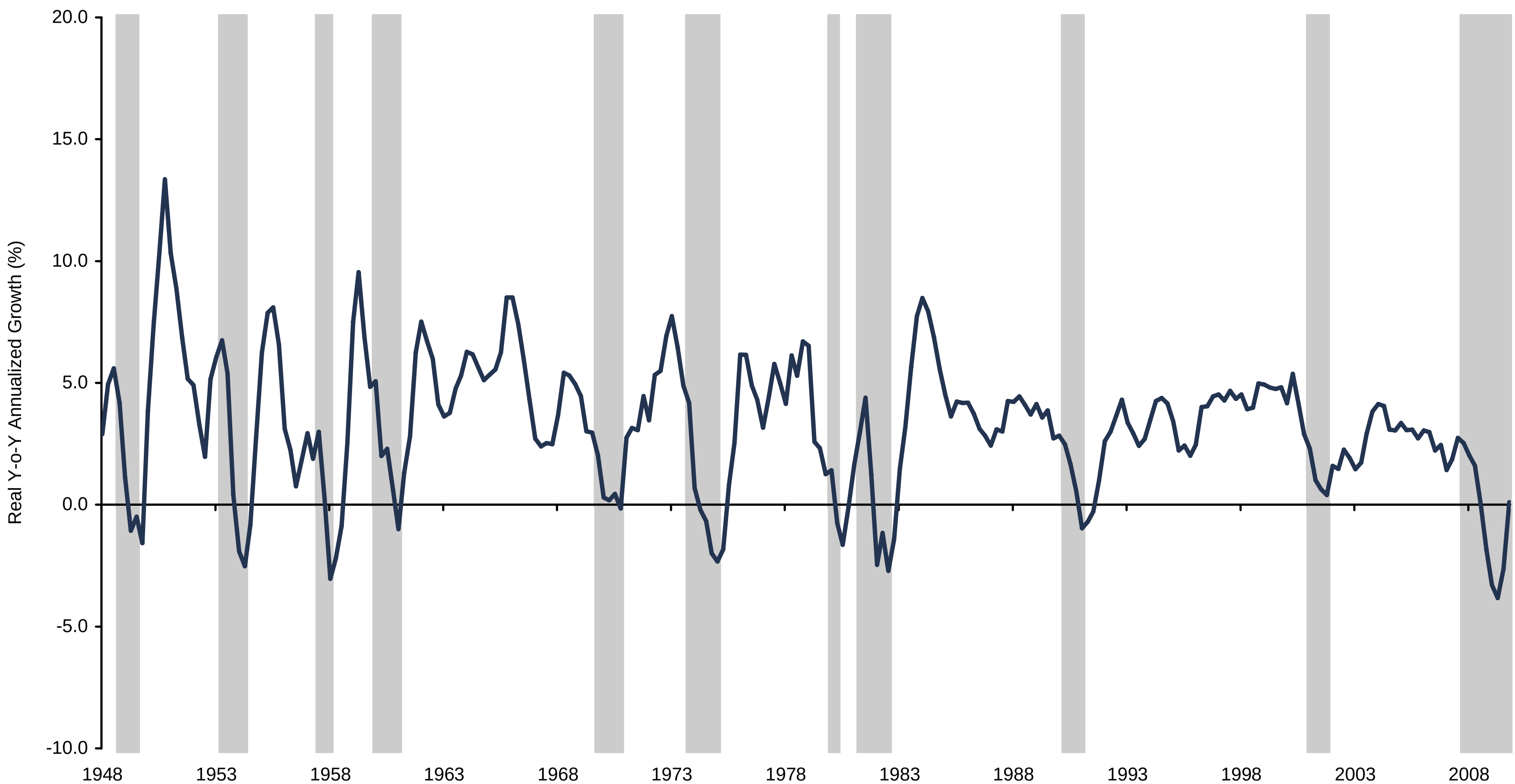
Source: Thomson Datastream.

Notes: Earnings data are calculated using Datastream price-earnings ratio data. Data labels represent recent peaks and troughs. The December 31, 2009, earnings per share values for financials and nonfinancials are $34.9 and $51.7, respectively.

Exhibit 7

U.S. GDP Growth (Year-over-Year)

March 31, 1948 – December 31, 2009



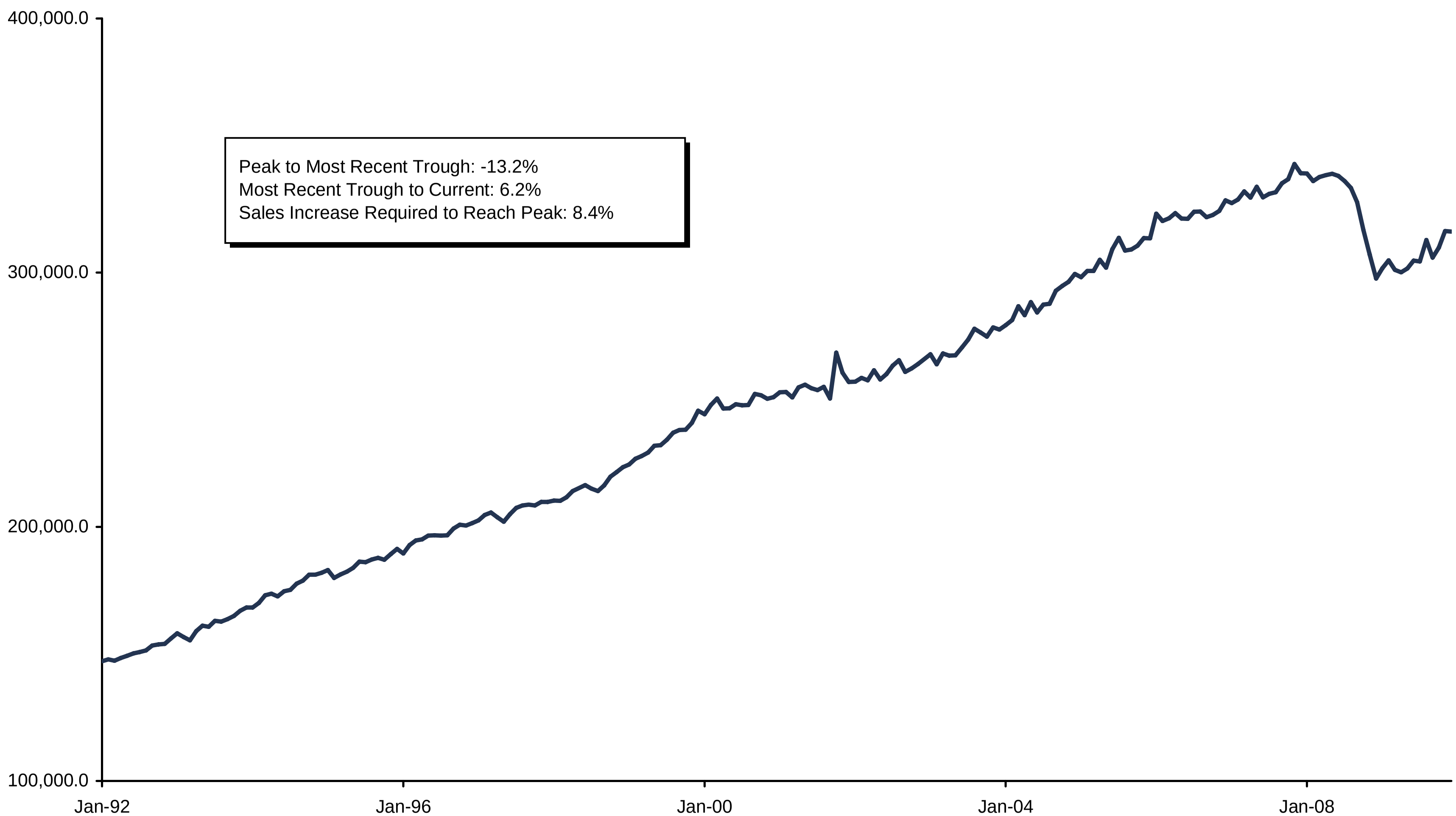
Sources: Bloomberg L.P. and Thomson Datastream.

Notes: Shaded areas indicate NBER-defined recessions. Quarterly figures are annualized.

Exhibit 8

U.S. Retail Sales

January 31, 1992 – December 31, 2009

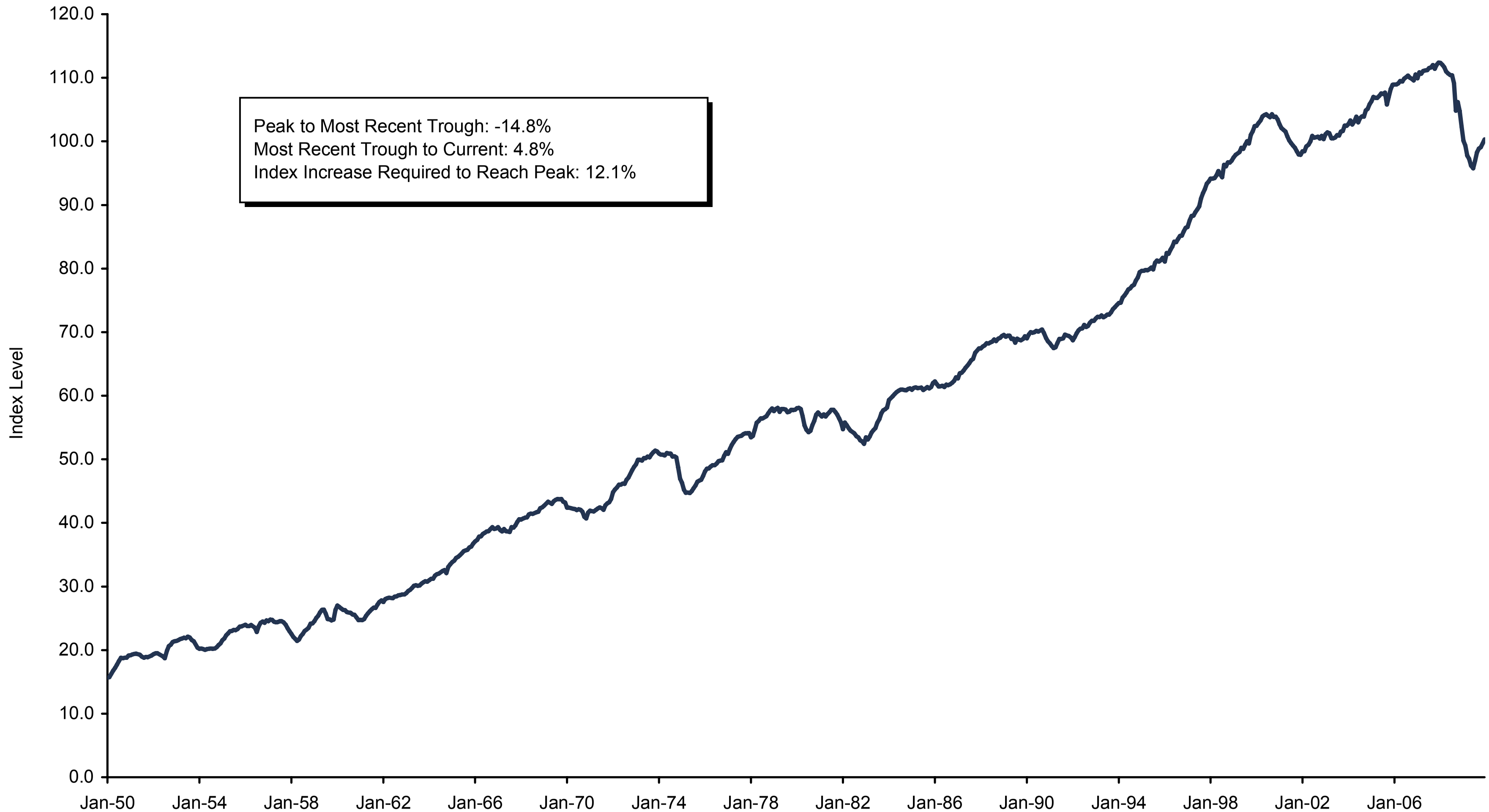


Source: Thomson Datastream.
Note: Data are monthly.

Exhibit 9

U.S. Industrial Production

January 31, 1950 – December 31, 2009

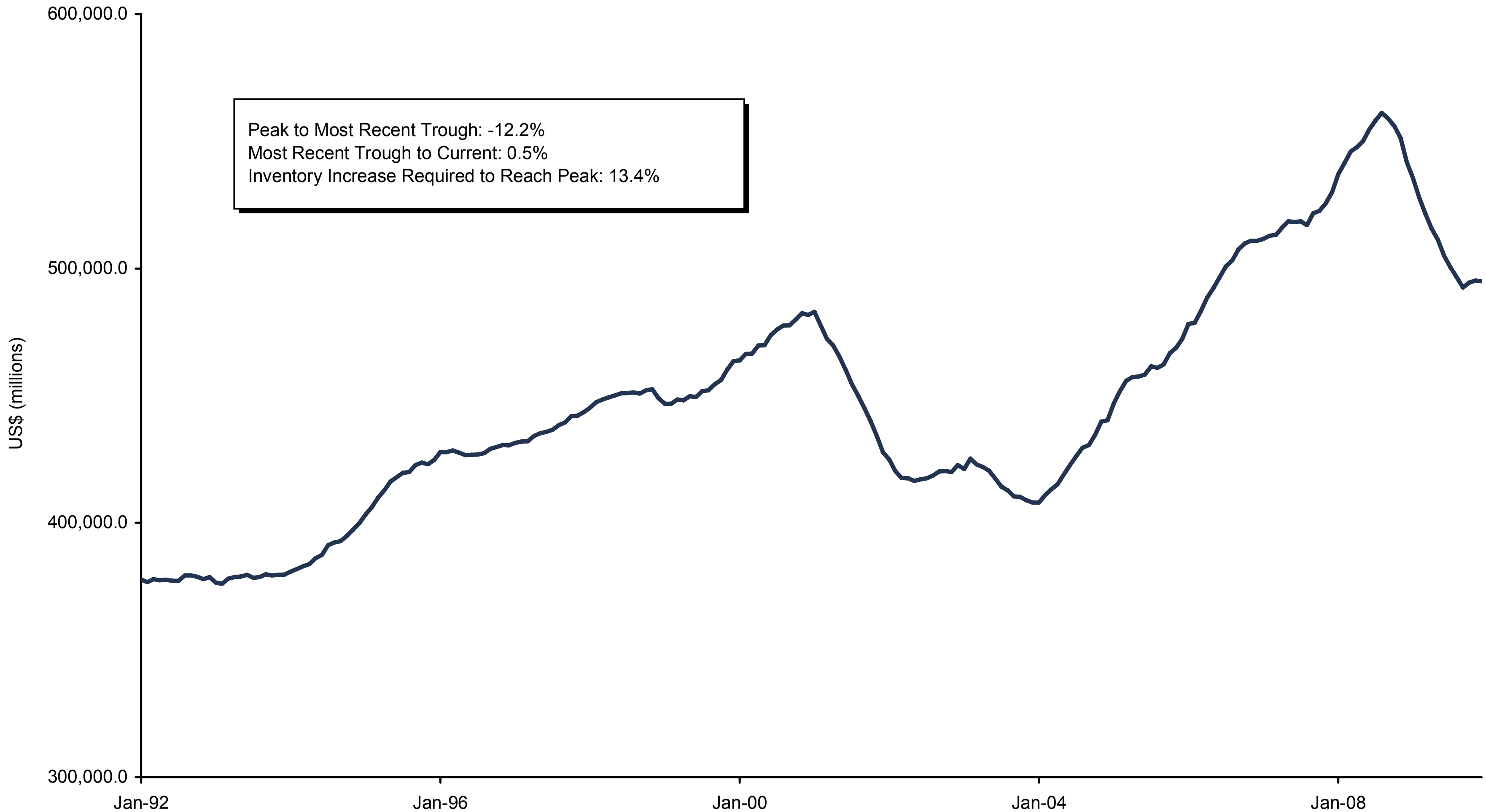


Source: Thomson Datastream.
Note: Data represent the U.S. Industrial Production index.

Exhibit 10

U.S. Manufacturing Inventories

January 31, 1992 – December 31, 2009



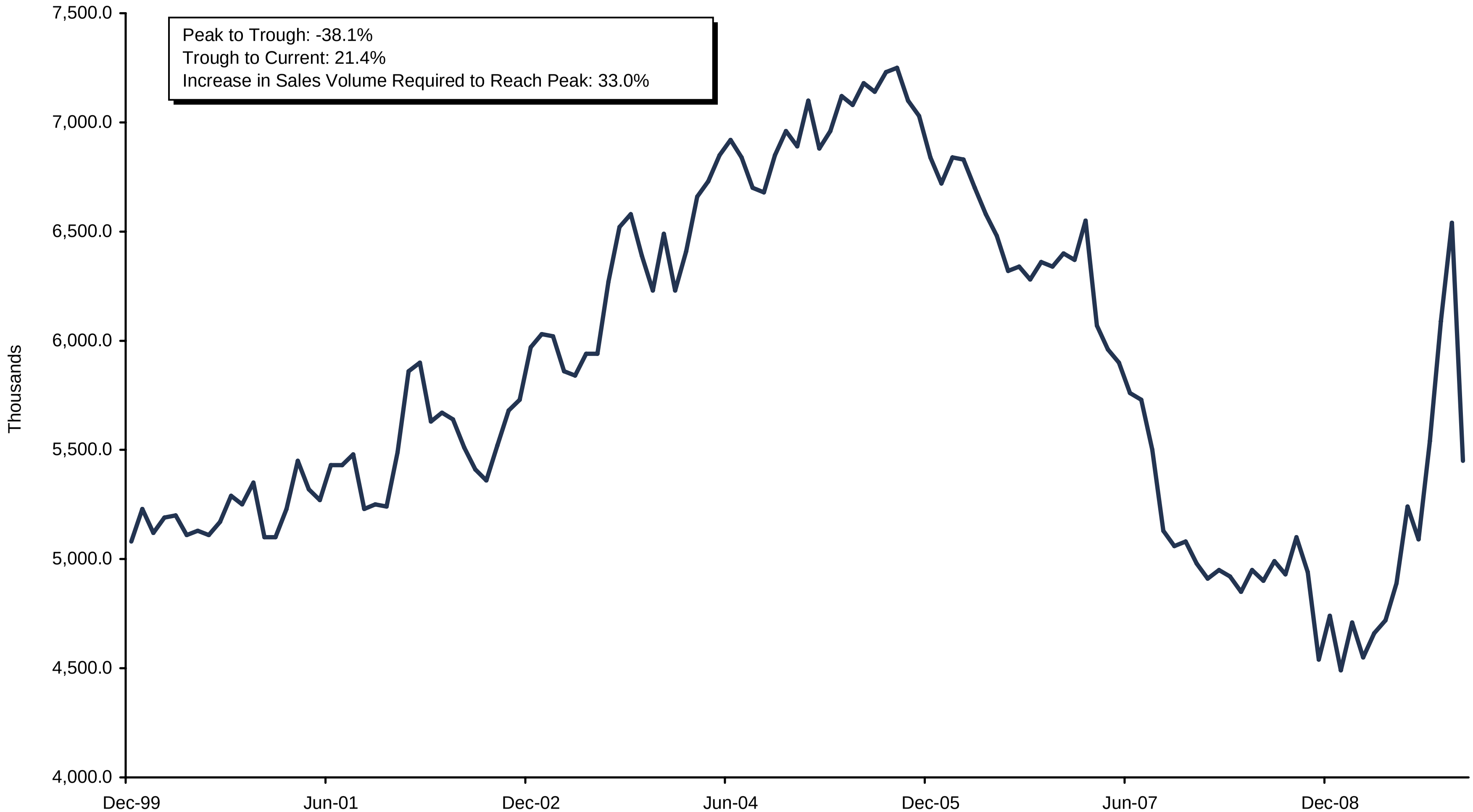
Source: Thomson Datastream.

Notes: Data are monthly. Inventories are on a non-LIFO basis as of the end of the month.

Exhibit 11

Existing Home Sales

December 31, 1999 – December 31, 2009

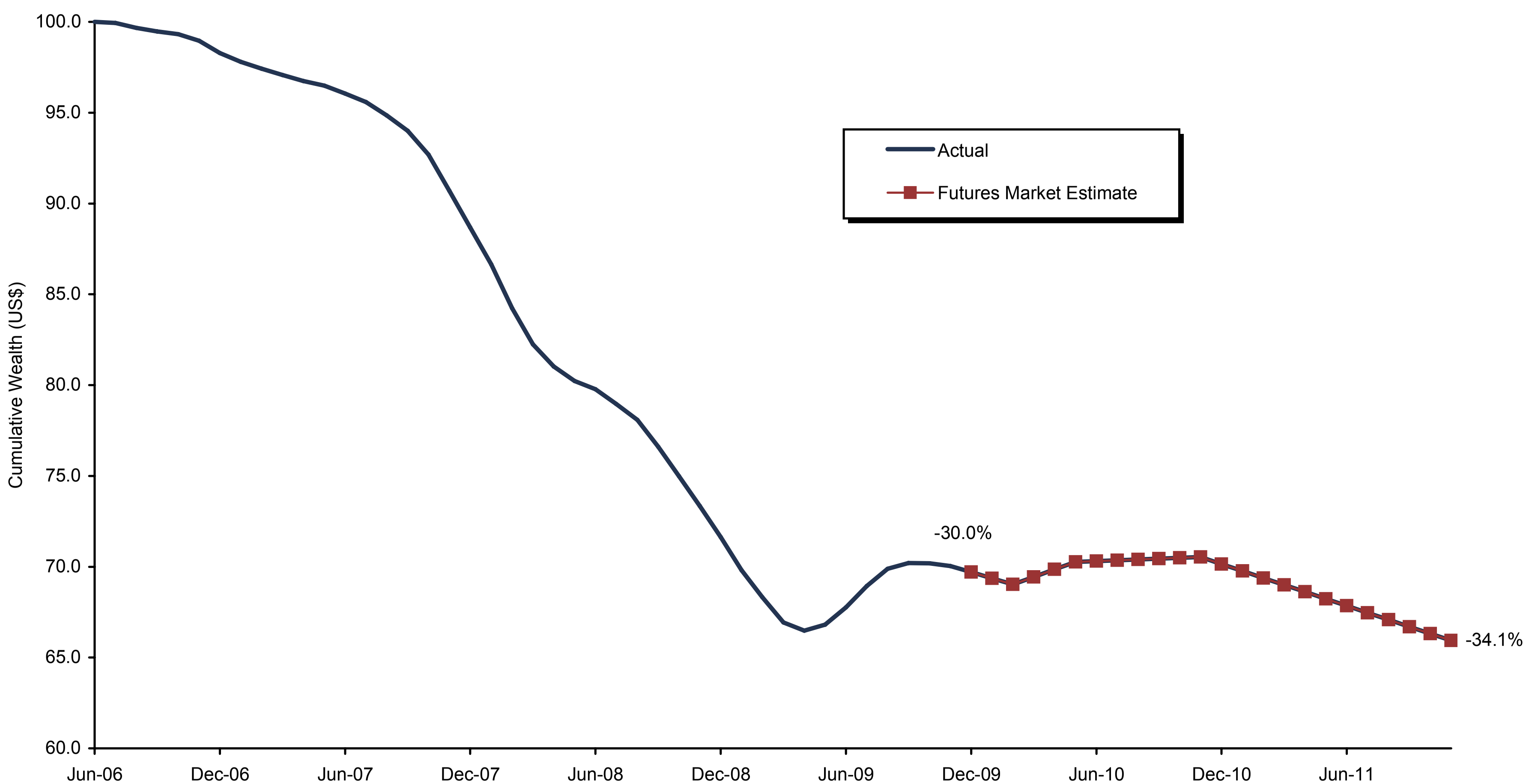


Source: Thomson Datastream.
Note: Graph represents rolling monthly annualized figures.

Exhibit 12

S&P/Case-Shiller Composite 10 Index

June 30, 2006 – November 30, 2011



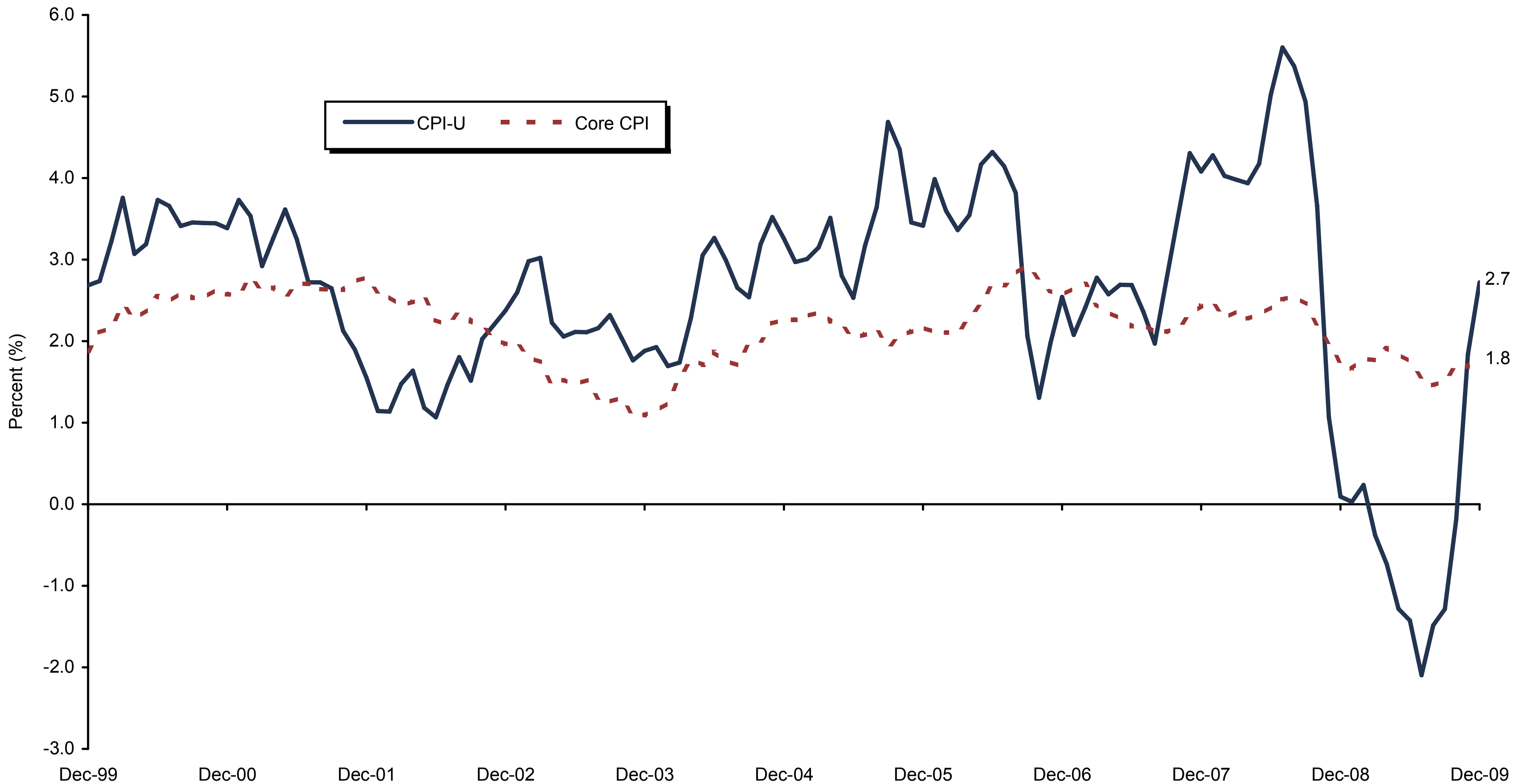
Source: Standard & Poor's.

Notes: Data are rebased to $100 as of June 30, 2006. Futures data are derived using property derivatives listed on the Chicago Mercantile Exchange. Actual data are through November 30, 2009.

Exhibit 13

Rolling 12-Month Consumer Price Inflation

December 31, 1999 – December 31, 2009

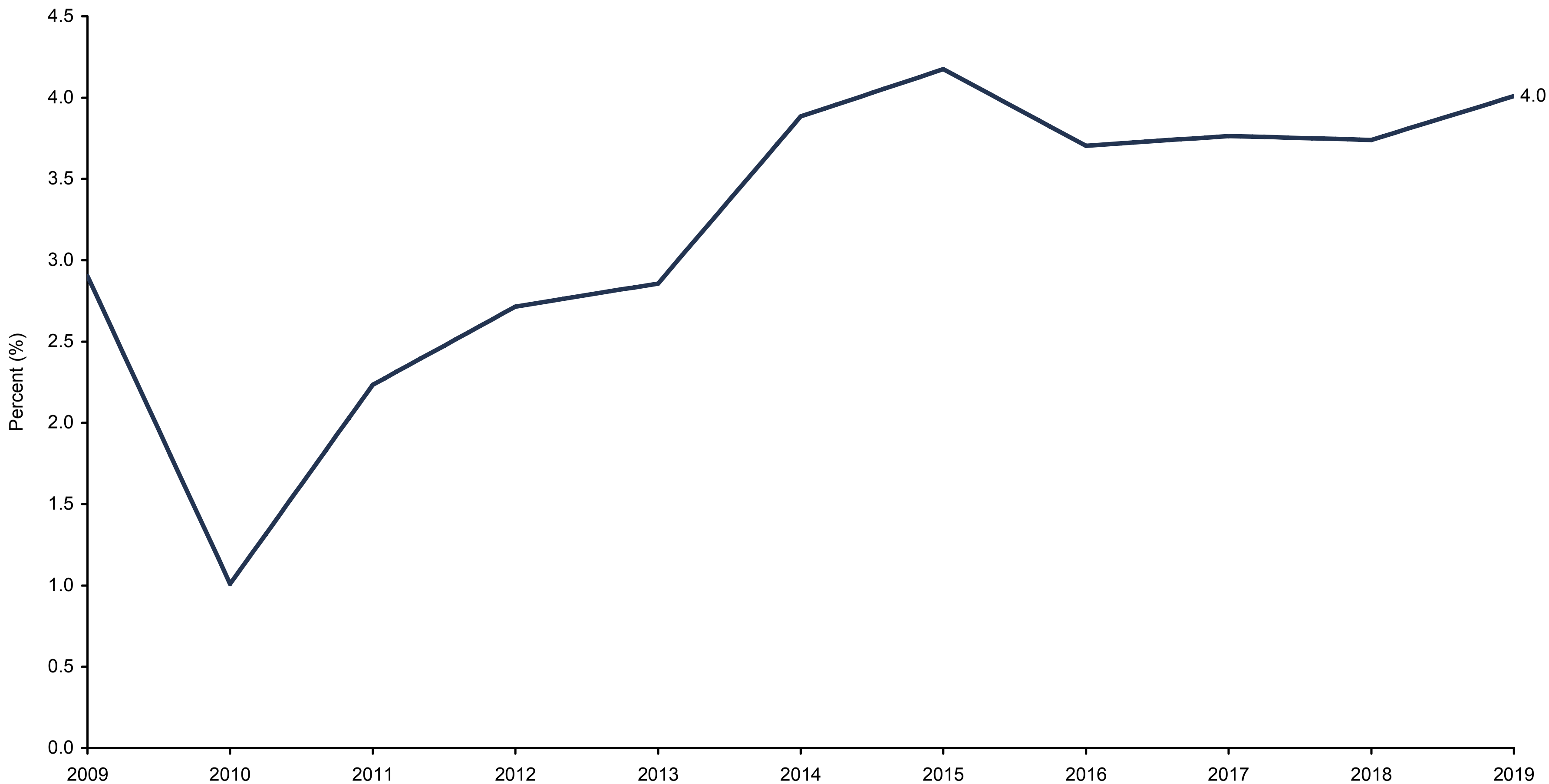


Source: Thomson Datastream.
Note: Graph represents monthly data.

Exhibit 14

U.S. Inflation Expectations

As of January 4, 2010

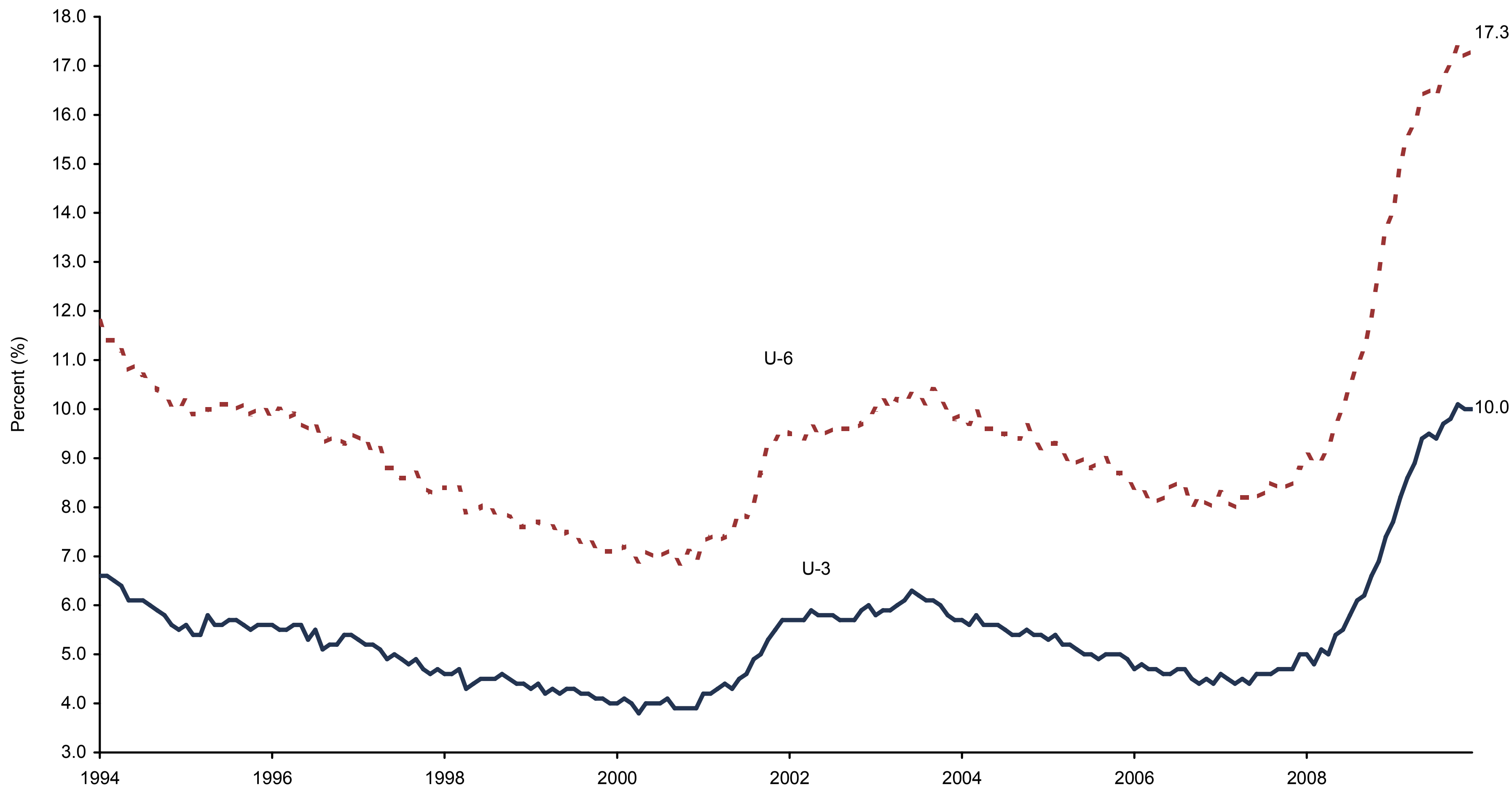


Sources: Bloomberg L.P., Thomson Datastream, and U.S. Department of Labor - Bureau of Labor Statistics.
Notes: Graph represents monthly data. Monthly inflation expectations data are linearly interpolated from annual zero coupon inflation swap rates, as of January 4, 2010, and are presented as trend-line figures.

Exhibit 15

U.S. Unemployment Rates

January 31, 1994 – December 31, 2009



Sources: Thomson Datastream and U.S. Department of Labor - Bureau of Labor Statistics.
Notes: Data are monthly. U-3 represents the official unemployment rate. U-6 represents total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons as a percent of the civilian labor force, plus all marginally attached workers.

Exhibit 16

U.S. Personal Savings as a Percentage of Disposable Income (Rolling Three-Month Average)

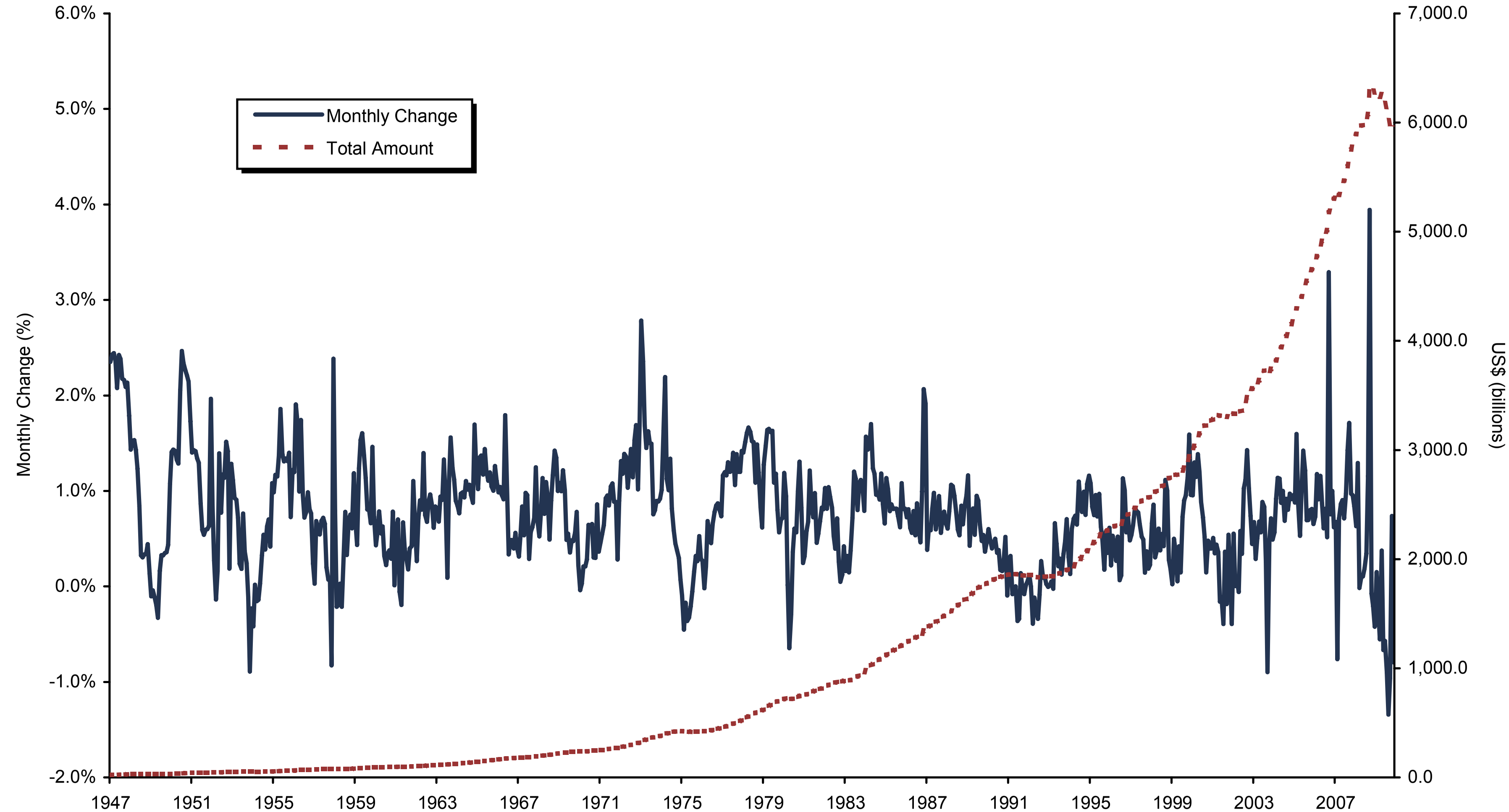
March 31, 1959 – December 31, 2009

Source: Thomson Datastream.

Exhibit 17

Commercial Bank Loans

February 28, 1947 – December 31, 2009

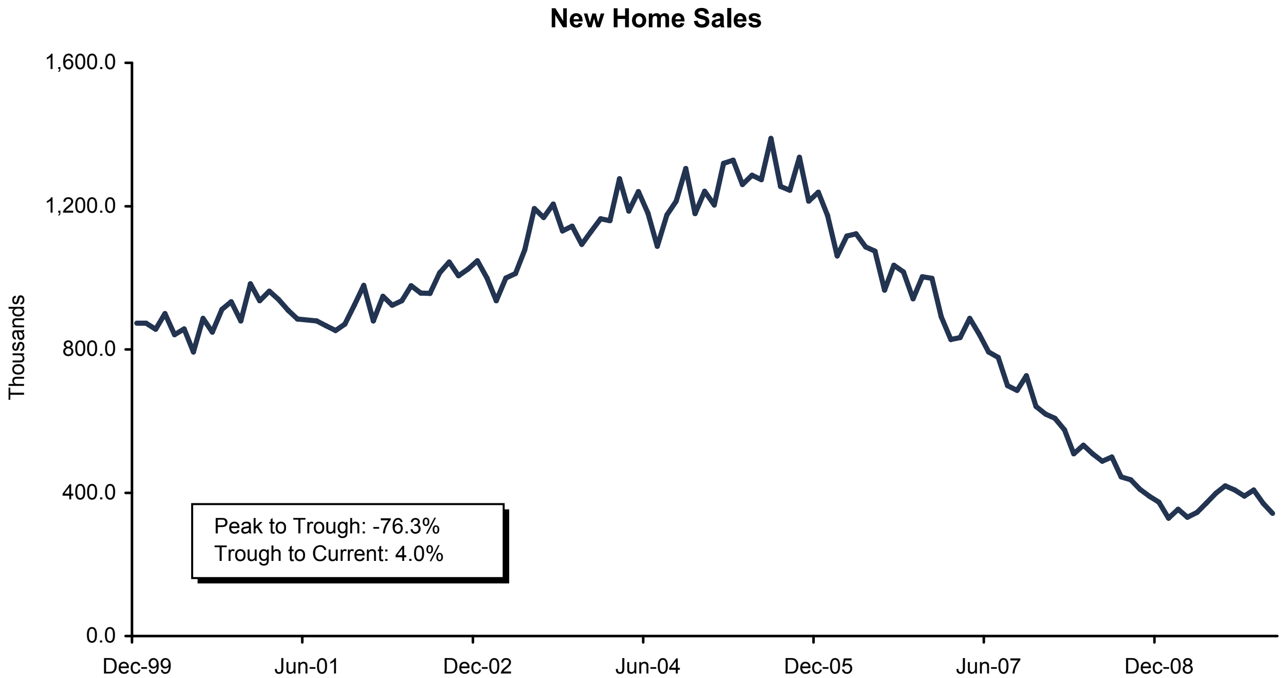


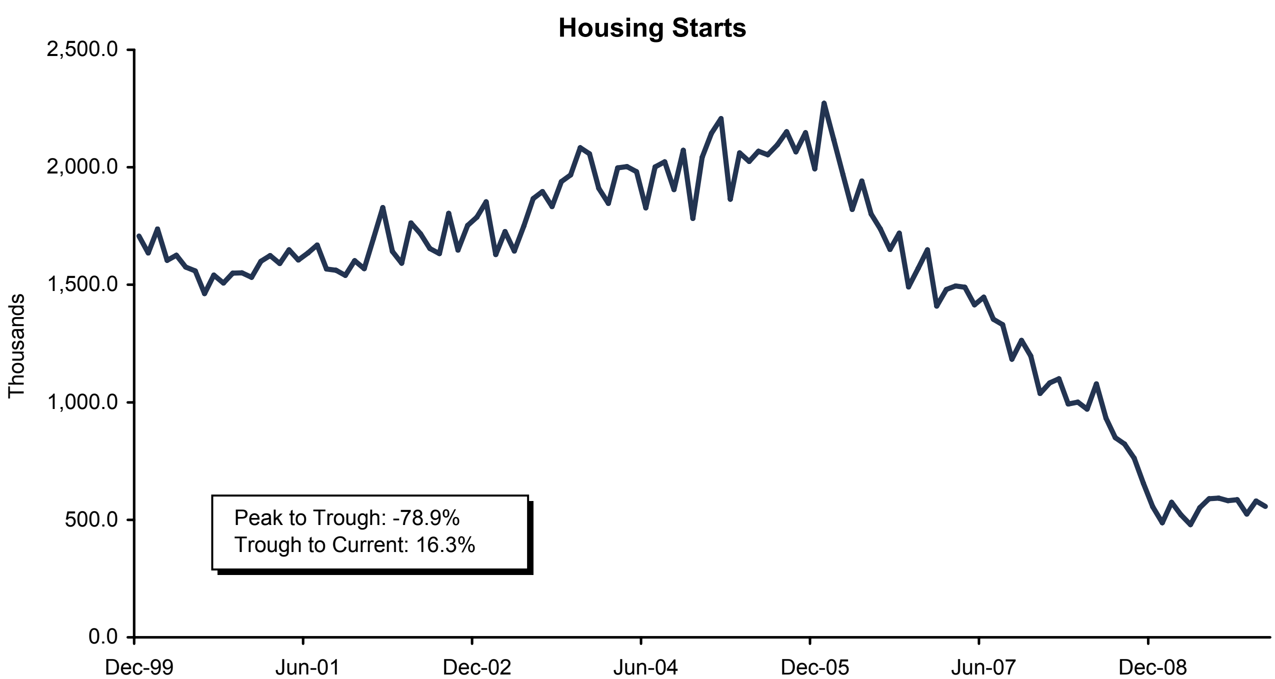
Source: U.S. Federal Reserve.
Notes: Data are monthly. Total amount represents sum of commercial and industrial, consumer, and real estate loans.

Exhibit 18

Housing Market Indicators

December 31, 1999 – December 31, 2009



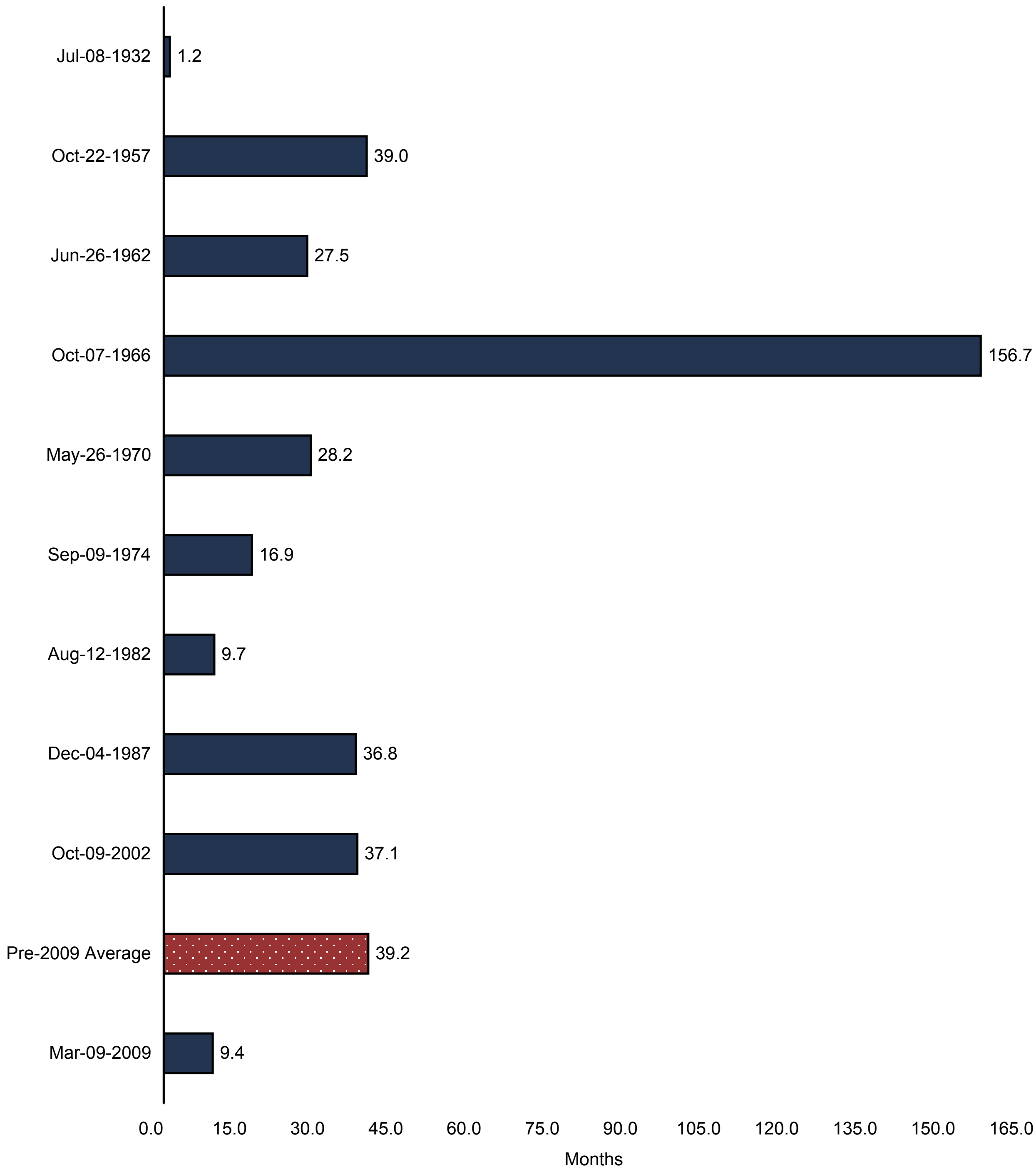


Source: Thomson Datastream.
Note: Graphs represent rolling monthly annualized figures.

Exhibit 19

S&P 500: Months from Trough to 64.8% Price Recovery

1928 – Present

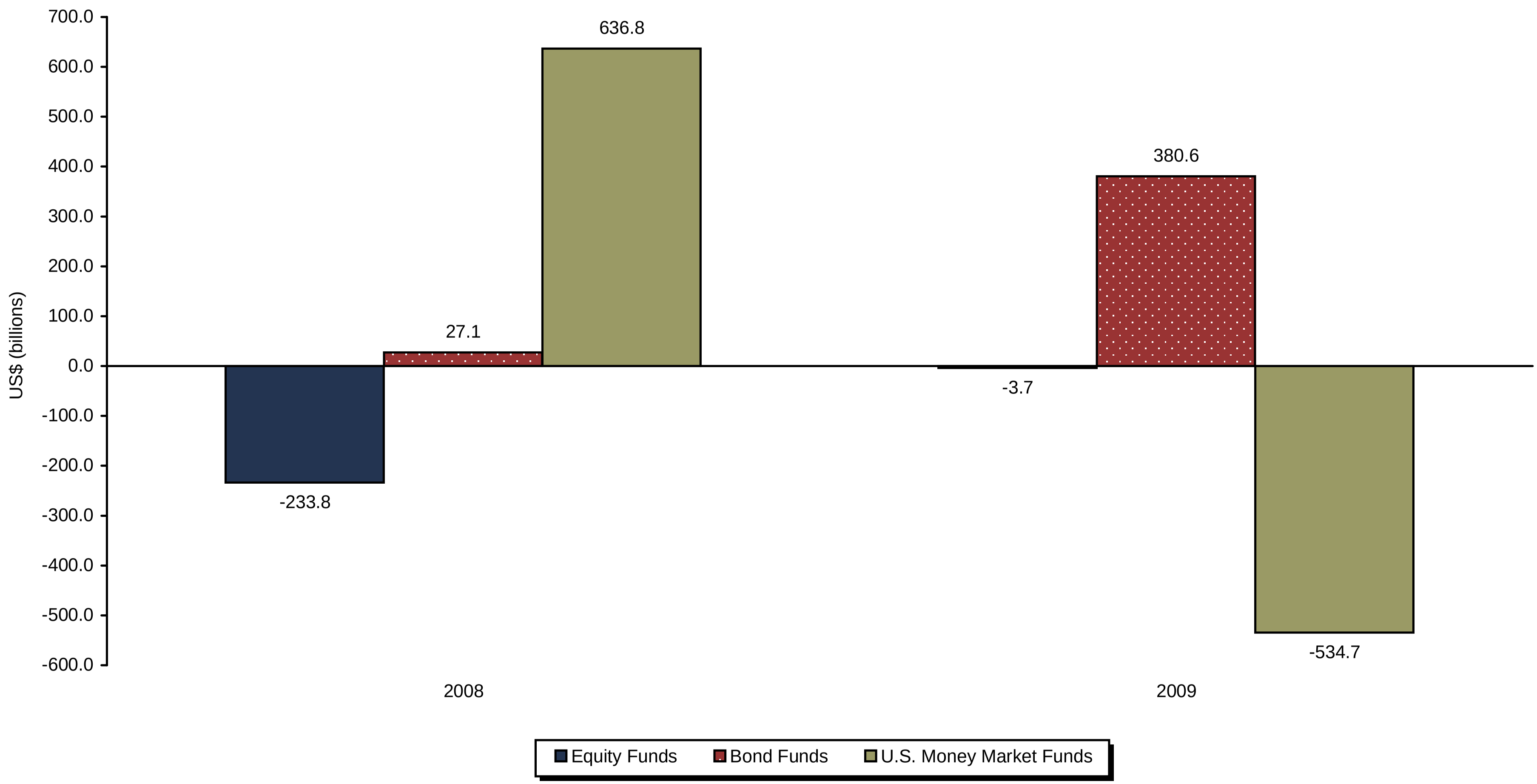


Sources: Global Financial Data, Inc. and Standard & Poor's.
Notes: Dates represent significant market troughs using daily price levels. The S&P 500 price rally from March 10, 2009, to December 31, 2009, was 64.8%.

Exhibit 20

Net Annual Inflows into U.S. Mutual Funds

2008–09



Source: Investment Company Institute.
Notes: Fund flows are derived from data collected covering more than 95% of U.S. fund industry assets and are adjusted to represent industry totals. Data for 2009 are through December 22, other than money market fund flow data, which are through November 30.

Exhibit 21

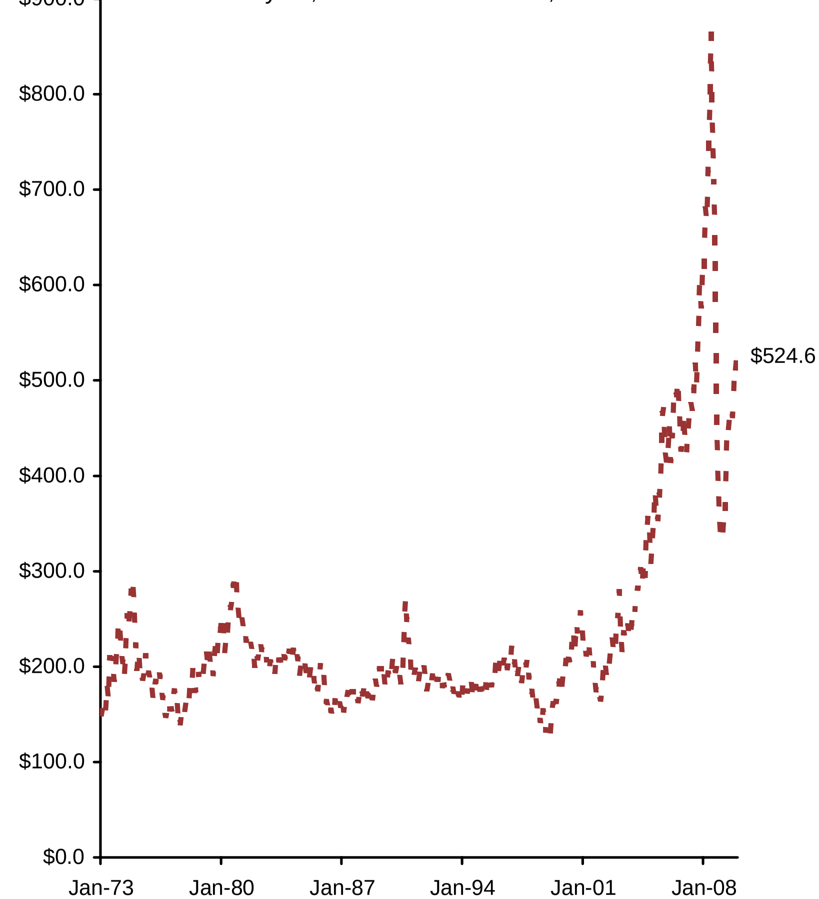
Commodity Prices

Historical Gold Prices

January 31, 1973 – December 31, 2009

S&P GSCI™ Commodity Spot Prices

January 31, 1973 – December 31, 2009



Source: Thomson Datastream.

Notes: Historical real gold prices are adjusted to January 1973 dollars. S&P GSCI™ data are in nominal terms.

Exhibit 22

Recessions

1926–2009

Expansion Peak	Recession Trough	Duration of Recession (Months)	S&P Price Begin	S&P Price End	S&P Price % Change	S&P 500 Earnings Per Share Begin	S&P 500 Earnings Per Share End	S&P 500 Earnings Per Share % Change	Trailing P/E Begin	Trailing P/E End	Trailing P/E % Change	Shiller P/E Begin	Shiller P/E End	Shiller P/E % Change
Aug-31-1929	Mar-31-1933	42.9	31.7	5.8	-81.6	1.5	0.4	-72.8	20.7	14.0	-32.3	33.0	7.4	-77.6
May-31-1937	Jun-30-1938	13.0	16.3	11.6	-28.9	1.2	0.8	-33.0	14.1	15.0	6.2	19.5	14.0	-28.3
Feb-28-1945	Oct-31-1945	8.0	14.3	16.7	16.4	1.0	1.0	3.2	15.1	17.0	12.9	12.7	14.5	14.7
Nov-30-1948	Oct-31-1949	11.0	14.7	16.0	8.8	2.2	2.4	6.8	6.7	6.8	1.9	9.8	10.2	4.0
Jul-31-1953	May-31-1954	10.0	24.8	29.2	17.9	2.5	2.6	2.9	9.8	11.2	14.6	11.9	13.5	12.8
Aug-31-1957	Apr-30-1958	7.9	45.2	43.4	-3.9	3.5	3.1	-11.1	13.1	14.1	8.1	15.6	14.2	-8.6
Apr-30-1960	Feb-28-1961	10.0	54.4	63.4	16.7	3.3	3.2	-5.9	16.2	20.1	24.0	17.0	19.6	15.6
Dec-31-1969	Nov-30-1970	11.0	92.1	87.2	-5.3	5.8	5.2	-9.9	15.9	16.7	5.2	17.5	15.4	-11.6
Nov-30-1973	Mar-31-1975	15.9	96.0	83.4	-13.1	8.0	8.5	5.6	12.0	9.9	-17.7	13.8	10.1	-26.5
Jan-31-1980	Jul-31-1980	6.0	114.2	121.7	6.6	15.0	14.8	-1.1	7.6	8.2	7.8	9.1	9.0	-1.0
Jul-31-1981	Nov-30-1982	16.0	130.9	138.5	5.8	15.1	12.9	-14.2	8.7	10.7	23.4	8.6	8.4	-2.0
Jul-31-1990	Mar-31-1991	8.0	356.2	375.2	5.4	21.4	20.9	-2.6	16.6	18.0	8.1	17.6	18.0	2.3
Mar-31-2001	Nov-30-2001	8.0	1160.3	1139.5	-1.8	45.4	25.9	-43.0	25.5	44.0	72.3	31.5	30.2	-4.0
Average		12.9			-4.4			-13.5	14.0	15.8	10.3	16.7	14.2	-8.5
Median		10.0			5.4			-5.9	14.1	14.1	8.1	15.6	14.0	-2.0
Post-1950 Average		10.3			3.1			-8.8	13.9	17.0	16.2	15.8	15.4	-2.6
Post-1950 Median		10.0			5.4			-5.9	13.1	14.1	8.1	15.6	14.2	-2.0
Dec-31-2007	Jul-31-2009	19.0	1468.4	987.5	-32.7	66.2	9.2	-86.1	22.2	107.5	384.5	25.7	17.7	-31.0
Dec-31-2007	Dec-31-2009	24.0	1468.4	1115.1	-24.1	66.2	50.7	-23.4	22.2	22.0	-0.9	25.7	20.4	-20.5

Sources: Robert J. Shiller, Standard & Poor's, and Thomson Datastream.

Notes: Earnings per share and trailling price-earnings (P/E) are on a trailing 12-month basis. Normalized real P/E ratios (Shiller P/E ratio) for the S&P 500 are calculated by dividing the current index price by the rolling ten-year average of inflation-adjusted earnings. Real earnings are deflated in terms of December 31, 2009, dollars. Beginning and end columns represent the value of the given metric at the beginning or end of a recession, respectively.