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INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Published Research Team

"2010 – The Year Ahead: New Normal Opportunities"
by Bank of America Merrill Lynch, December 6, 2009

In 2010, global GDP will grow 4.4% and equity markets will rise around the globe as production and consumption recover. Many of the drivers for a synchronized recovery are in place, with capital markets having healed and banks rebuilding balance sheets. Government policy will remain accommodative, given limited inflationary pressure and risk vigilantes that pressure governments not to withdraw stimulus. For bond investors it will be a return to more normalized returns, with credit spreads compressing somewhat, but pressure on longer-term interest rates offsetting some of the gains.

The global economic recovery in 2010 will be more muted than normal coming out of a deep recession. However, countries such as China that avoided a banking crisis and used aggressive stimulus are already experiencing strong growth. In the West, policy will remain accommodative, and the combination of low interest rates and continued government spending will be bullish for equity markets. Financial markets have largely normalized, creating a fertile environment for positive returns in 2010. While potential risks exist, such as elevated U.S. unemployment and the potential for a US$ crisis, authorities will do everything in their power to address them. Even if a sell-off were to occur, it should provide a buying opportunity, assuming U.S. consumer demand does not collapse and the Chinese growth story continues.

Global GDP growth will be 4.4% in 2010, higher than the International Monetary Fund and other forecasters anticipate. Expectations are overly pessimistic for three reasons. There is a natural tendency to underestimate growth coming out of a recession, as analysts who are overly optimistic fear they will be greeted with skepticism. Secondly, investors underestimate the power of the business cycle. In the four quarters after a U.S. recession, GDP typically increases 6% to 9%, with inventories alone accounting for 1.5 to 2.5 percentage points of this growth. Finally, central banks around the world have demonstrated a "do whatever it takes" attitude, and will not jeopardize the recovery in financial markets. Indeed, looking at the causes of the global slowdown, with capital markets having recovered and banks rebuilding capital, it is only housing that continues to be the main drag.

Global interest rates will rise modestly in 2010, but curves are expected to steepen. Central banks will wait longer than expected to hike rates, but increased bond supply and concerns over sovereign deficits will push up longer-term interest rates. Despite the bullish forecast for GDP growth, rate hikes will also be delayed as inflationary pressures are contained by excess capacity. Monetary policy is less inflationary than it appears, as the transmission mechanism, whereby bank balances are converted to loans that spur spending and increase prices, is not operating normally. As banks continue to repair balance sheets and curtail lending, the central banks will have a sufficient opportunity to mop up some of the excess liquidity. Rate hikes have already occurred in countries like Australia and Norway, where output gaps are smaller, but expect the Federal Reserve (Fed) and the European Central Bank to wait much longer. In fact, the Fed may be on hold throughout 2010, as its focus on both inflation and employment, and its lower concerns about asset bubbles, distinguishes it from other central banks.

Looking at the equity markets, it is tempting to call for a drop in 2010 after the rally of 2009. And after a negative return in the S&P 500 for the last decade, sentiment remains negative, as evidenced by continued flows of U.S. retail investors into fixed income rather than U.S. equities. However, low interest rates, quantitative easing, and large deficits will continue to support the asset class. The risk vigilantes will also support continued government intervention, as any activity that may be deflationary will be met by sales of risk assets, forcing policymakers to change tacks. The risk to this outlook is the current divergence between Main Street and Wall Street, and equities will eventually suffer if economic growth does not accelerate. In the mean time valuations are not challenging, and the positively sloped yield curve is bullish for growth. The S&P 500 is expected to end the year at 1,275 and the MSCI All Country World Index should rise to 350. Given that emerging markets' consumers continue to offer the best investment play, large-cap emerging markets stocks and European, Japanese, and U.S. multinationals with exposure to these consumers are preferred investments.

For credit investors, 2010 should see a move back to more normalized returns, following an exceptional 2009. Retail inflows to the asset class should subside as the opportunity for double-digit gains disappears. High-yield bonds could see a total return of around 10% but investment-grade credit is likely to see a total return of just 2% to 3%. Credit spreads will continue to compress, but to a much smaller degree than in 2009, and rising interest rates will offset some of the gains. High yield should outperform investment grade as liquidity remains abundant and as a strong equity market allows companies to reduce leverage. The largest risk for credit investors is government policy error, such as a premature rate hike or a trade disagreement between the United States and China that leads to a weaker U.S. dollar, unintentionally causing higher interest rates in the United States.

"Bear, Unbowed"
by David Rosenberg of Gluskin, Sheff + Associates, Inc., Welling@Weeden, January 8, 2010

The economy is in the midst of a *secular* credit contraction and will likely encounter significant pockets of economic weakness in coming years. Such weakness may come to the forefront as early as next year, which would likely result in economic and earnings growth significantly different than current forecasts. Specifically, the current consensus of $76 in operating earnings per share (EPS) translates to a 14% increase in nominal GDP based on data since 1955. Such an increase was last recorded in 1951.

Most mainstream economists continue to view the current cycle through the lens of a typical contraction/recovery cycle in the post–World War II period. Those cycles, however, did not involve credit contractions; rather they were business cycle downturns in the context of a secular *expansion* in credit. Events are going to unfold differently this time around given that the economy is in the midst of a secular credit *contraction*. Indeed, the economy is unlikely to embark on a sustainable recovery, and significant pockets of weakness can be expected over the next few years. One of the drivers will be a shift in consumer behavior given the collapse in credit and asset values we have just experienced, as consumer attitudes toward homeownership, discretionary spending, and borrowing are likely to be altered for years.

Such weakness may come to the forefront as early as next year and result in an economic outcome that is considerably different than the current economic consensus. Consumers are being buffeted by both falling asset prices and the ongoing need to deleverage. Housing prices are down roughly 30% from peak levels, and recent stabilization has only been brought about by government intervention (e.g., foreclosure moratoriums) and is not justified by current fundamentals. Indeed, home prices have yet to mean revert toward rental rates. Doing so would imply another 10% to 15% decline in prices. A decline of this magnitude would increase the number of homes with negative equity from 15 million to 30 million (roughly half of the mortgage population). In terms of deleveraging, the ratio of household debt to disposable income is 125% today. While down slightly from its 2007 highs, to revert to the historical mean of 60% would imply that more than $7 trillion of household credit needs to be extinguished. This will put downward pressure on inflation, interest rates, and corporate profits. Thus the bond markets probably have it wrong, deflation is the biggest near-term risk in the United States, fueled also by excess capacity and elevated unemployment.

Another headwind for the economic outlook will come from state and local governments. Tax revenues are down as much as 10% from a year earlier and with these entities almost twice as large as the federal government, their budget woes will offset much of the fiscal stimulus coming from Washington. Finally, small businesses, which account for roughly two-thirds of private sector employment, appear to be falling further behind in their loan repayments and thus are unlikely to increase employment or capital spending in 2010.

Despite these headwinds, the stock market has discounted an economic environment even more vibrant than a typical postwar recovery. Based on historical precedent, a percentage point of nominal GDP growth typically generates 2.5 percentage points of corporate earnings growth. With the 2010 consensus forecasting $76 of operating earnings per share (EPS), this would require a 14% increase in nominal GDP, which is extremely unlikely and was last seen in 1951. The economic consensus sees just 4% nominal GDP growth next year. Such growth would imply EPS of $62, 18% lower than the current consensus and expensive based on a forward price-earnings ratio of 18. Thus, there is quite a dichotomy between current economic and earnings growth forecasts.

The market, however, may remain divorced from the economic reality for an extended period, as evidenced by last year's earnings performance. Indeed, at this time last year, the consensus was calling for $77 operating EPS in 2009. Earnings, however, are currently estimated to be $56 for 2009. Despite the miss, the S&P 500 managed to rally 23% in 2009 even though earnings were roughly $22 less than what was being priced in at the beginning of the year.

Interestingly, retail investors have not participated in the rally to this point. In fact, despite a nine-month, 65% rally in equities, retail investors have continued to sell into the rally and rebalance portfolios. While equity bulls believe the next leg up in the market will be driven by retail investors increasing their equity exposure, the fact that retail investors have just 7% of their assets in fixed income and 25% of their assets in equities suggests a continued need to rebalance. If retail investors continue to pull funds out of stocks and pour them into bonds, equities may have trouble finding a marginal buyer. Thus, valuations would be more likely to come down through price declines than earnings improvement over time.