

Quarterly US Investment Outlook

October 2009



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Executive Summary

While economic growth may achieve sub-par levels relative to past recoveries, as the consumer faces the twin challenges of slow re-hiring and high debt levels, we believe that the US economy may deliver upside surprises over the next year due to strong global growth and high corporate profit margins. Inflation represents a serious longer-term issue, given the unprecedented monetary stimuli represented by a zero Federal Funds rate, the Federal Reserve's (Fed) quantitative easing programme and the seriously deteriorating fiscal situation at both the federal and state levels. Velocity of the monetary base has declined, however, so that inflation does not pose an immediate threat.

In addition, we do not believe that the US dollar faces an imminent crisis. While currencies of countries with high exposure to commodities offer value vis-à-vis the US dollar, the more favourable economic outlook of the US may support its value in the near term compared to the other major developed market currencies, i.e. the euro and the yen. In this environment, we believe that credit and equity markets will outperform. Corporate credit markets continue to offer spreads modestly above long-term averages, while default risk has declined markedly; equity markets are still attractively priced, based on our expectations of a recovery in the coming year, coupled with the benefit of relatively high corporate operating leverage.

Economic Outlook: Some Signs of Encouragement

We believe that the US economy should expand by 3.0% in the second half of 2009, for year-over-year GDP growth of -2.5%, followed by GDP growth of 3.0% to 4.0% in 2010. The consumer faces headwinds of high unemployment of 9.8% (which we believe will peak in the next six months at over 10%), as well as high debt levels relative to income. Yet leading unemployment indicators, including the four-week moving average of initial unemployment claims and demand for temporary workers, suggest that unemployment should peak in the near future and begin a slow decline during 2010. Apart from consumption, we find several encouraging indicators for economic growth over the next year.

Corporations should benefit from increasing international sales, reflecting strong global growth, particularly in emerging markets, combined with improved US competitiveness, due to the decline of the US dollar. It is important to note that companies represented in the S&P 500 Index derive more than 40% of their revenues from outside of the US. In addition, non-financial corporate profit margins have held up better than in recent past recessions, as companies have been quick to cut costs, including labour costs, and have benefited from just-in-time inventory management. Higher international sales and high operating leverage may mean that companies will deliver better earnings over the next year, particularly in comparison to weak fourth quarter 2008 profits. In addition, higher exports could lead to rebuilding of inventories and increased business fixed investment.

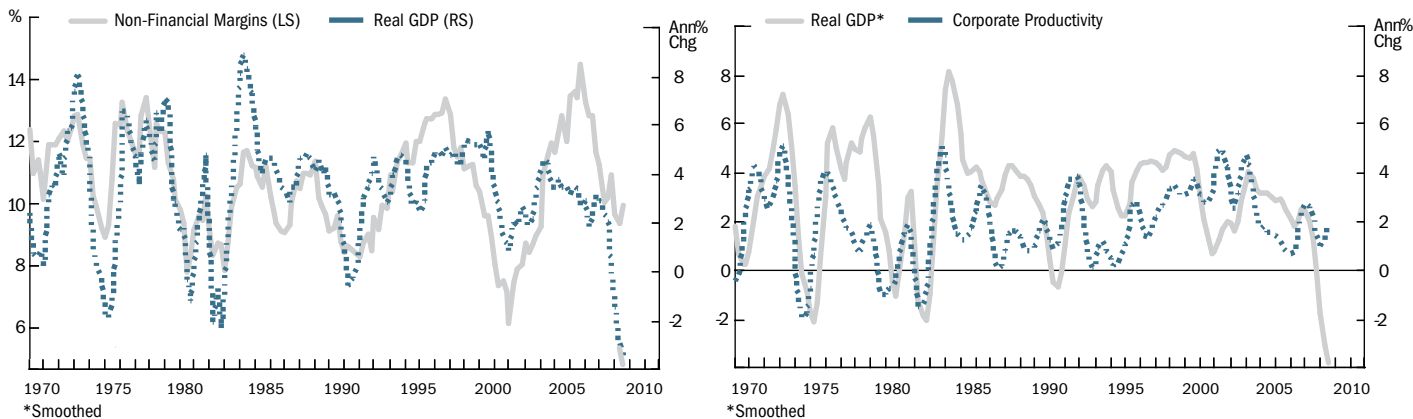
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Non-Financial Corporate Profits: Stronger than in Past Recessions

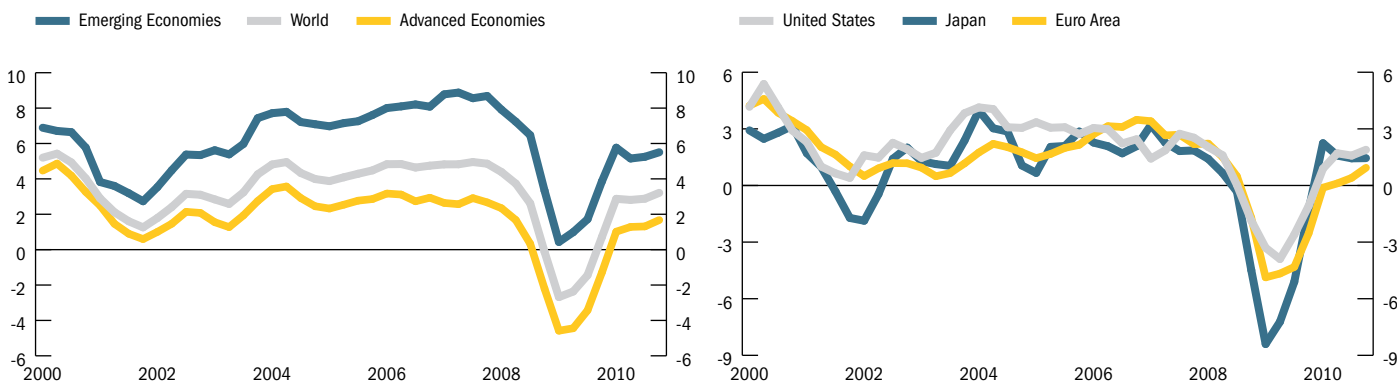
Annual percentage change in real GDP vs. non-financial profit margins and corporate productivity



Source: BCA Research, October 2009.

Supportive Global Economic Environment

Year-over-year change in real GDP



Source: IMF Global Outlook, October 2009.

Short Term, Stimulus Should Continue to Support Growth

The US\$787 billion economic stimulus package should also contribute to economic growth; almost 80% of the funds remain to be spent over the next two years, with the bulk spent until June of 2010. While the long-term effectiveness of the stimulus is debatable, we believe that it will contribute approximately 1.5% on an annualised basis in each of next four quarters until 30 June 2010. In addition, with stabilising home prices and attractive mortgage rates, residential fixed investment should finally contribute to economic growth, after having been a net drag on growth over the past three years, when it fell almost 70%.

US Dollar: Downward Pressure, No Imminent Crisis

An orderly decline in the US dollar could further improve export demand for US firms. The US dollar may face continued downward pressure from relatively low rates, as well as inflation risk presented by its high debt/GDP and monetary stimulus, but we do not believe that it faces a crisis. At this early stage of recovery, it is not unusual for the US dollar to weaken; in fact, it has only retreated to the June 2007 levels prevailing before the financial crisis. Furthermore, China, other Asian economies and even the European Union have a vested interest in maintaining the value of the US dollar. China relies on the US as its primary export market and is the largest foreign creditor of the US. The European Union seeks to maintain the competitiveness of its exports globally against the United States. As the economic recovery takes hold, the Fed must address its exit strategy, including raising rates, which will reduce pressure on the US dollar.

Near-Term Inflation Not a Concern

Finally, we do not believe that inflationary pressures are sufficient in the near term to put undue pressure on the US dollar. It is true that the monetary base has increased with the Fed's expansion of its balance sheet to over US\$2 trillion, which has generated US\$920 billion of excess bank reserves. Yet those reserves are not used by the banks because banks are not lending – both corporate and consumer loan activity have declined significantly over the past year, as is evident in measures of velocity of the money supply. Until lending and demand for money increases, consumer inflation should not increase significantly. As demand for money rises, we believe that the US faces an inflation threat not seen since the 1970s. Whether that inflation materialises depends on the timing of the Fed's withdrawal of the monetary stimulus, particularly in light of developing tensions over expanding deficits and additional costs, including the healthcare reform.

We are encouraged that many of the programmes introduced by the Fed have built-in expirations. In addition, the Fed's plan to potentially immunise excess reserves by increasing interest on reserves, and engaging in reverse repo transactions with banks and money market funds, may prove effective as part of their exit strategy. We must note, however, that the Fed has not always demonstrated effective timing in reducing excess liquidity.

Market Outlook: Attractive Opportunities in Credit and Equities

Despite their record year-to-date returns, we believe that credit markets offer attractive value, particularly when compared to Treasury markets, in which real yields are at multi-year lows. We also find equity markets attractively priced, particularly in light of the potential for higher-than-expected corporate earnings.

Corporate credit markets are currently priced at spreads above long-term averages: investment-grade corporates offer spreads of approximately 230 bps, approximately 70 bps over long-term levels; high yield corporates have current spreads of approximately 800 bps, compared to a long-term average of 560 bps. Default and refinancing risk in these markets have declined dramatically, reflecting the improving economy, but also the robust new issue market. The investment-grade corporate market is projected to achieve an all-time record new issuance of over US\$1 trillion for the year. In 2009, the high-yield market has witnessed US\$120 billion of new issuance, much of which has been used to refinance upcoming debt maturities. These record new issuance levels, together with the economic recovery, should result in a decline in default rates over the next year to near long-term averages.

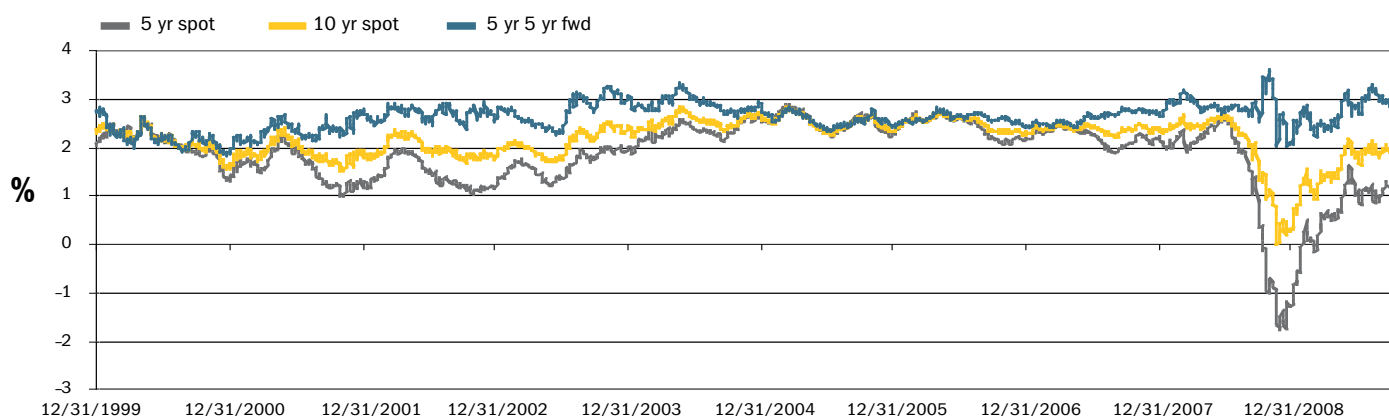
The floating rate bank loan market also offers compelling value, particularly in light of its role as an inflation hedge. Bank loans have benefited and may continue to benefit from limited new issuance and take-outs (approximately 30% of 2009 high-yield issuance refinanced bank debt). While bank loan yields of 7% are lower than the 10% available from high-yield bonds, they offer two advantages: yields will adjust as the London Interbank Offered Rate (LIBOR) increases when the Fed begins to raise interest rates, and they hold a more senior, often secured, position in the capital structure. We also continue to find select attractive opportunities in the non-agency MBS/ABS sector. While the PPIP programme and relative value investors have pushed yields lower, our dedicated credit mortgage team has still been able to find certain issues offering high single-digit returns.

Currencies Offer Value for Selective Investors

We continue to believe that currencies of countries with high exposure to emerging market economies offer value, although we recognise the higher risk inherent in this view should the Fed increase rates sooner than anticipated. Currencies of countries that have exposure to a broad range of commodities, such as Australia, or ones with more focused commodity and energy exposure, such as Norway and Brazil, look attractive, especially in light of their more disciplined monetary and fiscal policies and strong balance sheets. On the other hand, we believe that the US dollar is undervalued relative to the euro, the pound sterling and the yen. The US is projected to achieve higher economic growth in 2010 than either Europe or Japan, while the relative level of federal debt/GDP is comparable to the Eurozone and lower than that of Japan.

TIPS Markets Are Near Fair Value

Breakeven Inflation, until September 2009



Source: Macroeconomics Advisers, 28 September 2009.

We believe that US Treasury markets, including TIPS, are less attractive than credit markets on a relative value basis. As the above chart indicates, real yields stand at multi-year lows. All Treasuries, including TIPS, face the risk of rising real yields as economic growth improves. In light of low demand for money for bank lending and 0% money market rates, however, we do not believe that Treasury yields will face significant upward pressure in the near term. In addition, US banks and individuals, as well as foreign investors, continue to invest in US Treasuries, supporting current yield levels.

Finally, we believe that the US equity markets look attractive at current levels, which we value at an estimated 15 to 16 times 2010 earnings. Given the possibility for an upside surprise from strong global growth, high operating leverage and the significant S&P 500 Index exposure to international growth, we believe that equities may outperform bonds.

Conclusion

These represent historic times for investors. Unprecedented monetary and fiscal stimuli globally have helped bring about a recovery in the financial markets. It is anticipated that this recovery will begin to find its way into the real economy over the coming year. The longer-term threats posed by these actions – in the US, whether the Fed will withdraw the stimulus on a timely basis to prevent inflation, how the US will deal with its debt and deficit – must still be faced.

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Date of First Use : 30 October 2009.

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