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A Quarterly Review of Economic and Market Developments

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BAILARD INTERVIEW

Looking Forward After a Year of Reversals

Chief Investment Officer Sonya Thadhani discusses Bailard's investment outlook after an extraordinary 2009.

Sonya Thadhani, CFA
Chief Investment Officer

Sonya, in retrospect, how would you describe the past year?

2009 was a year of stunning reversals. After shocking losses of anywhere from -30% to -70% in the world's stock markets in calendar 2008, global equities continued their steep slide in the first two months of 2009. During this two-month period, the S&P 500 quickly lost an additional 25% of its value as it discounted an "end of the world" scenario. Things could have gotten worse, but fortunately they didn't. The world's stock markets turned in March, and when they turned, they turned with a vengeance. In the nine months from March to December of 2009, global equities saw their sharpest uninterrupted rally since 1932. The S&P 500 moved 65% off of its lows, the CBOE volatility index (which has often been quoted as a measure of investor sentiment) dropped by 45% over the course of the year, and U.S. Treasury yields moved higher. A year that had started with extreme panic ended on the more complacent end of the anxiety spectrum.

Do you think the U.S. stock market rally has gone too far?

In a word, yes. At the end of 2008, we argued that equities were extremely undervalued and that extreme periods of either over or undervaluation historically have always corrected themselves.

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So a rally after such a major correction was to be expected. The question we ask ourselves now is, "What is being priced into this stock market rally?" In our view, a move of such an extreme magnitude has actually resulted in the U.S. stock market going from being extremely undervalued to somewhat overvalued. According to the consensus, S&P 500 earnings are expected to grow 24% in 2010, a number that seems overly optimistic to us. Companies can fail to meet overly optimistic earnings expectations even in a recovering economy. Other red flags include the above trend growth in earnings revisions and the fact that volatility has been completely priced out of this market.

Our concern is that the stock market has priced in an over-optimistic view of this recovery and is vulnerable to some setbacks.

Are there other reasons why you are concerned?

Yes. At the end of 2008, we cautioned against becoming overly pessimistic after a painful year; at the end of 2009, our caution is to not become too optimistic after a strong rally. Investors seem to be treating this as a normal economic cycle, but past recessions that were triggered by financial crises have tended to take a lot longer to resolve. The economic environment continues to be a risky one. Although our base case calls for a muted recovery, we believe considerable systemic issues still remain.

Much of the consensus outlook for positive GDP growth is based on an expected moderation in inventory reductions. After eleven consecutive quarters of inventory reductions, a lower level of inventory liquidation should have a positive impact on GDP, which is consistent with recoveries from prior recessions. What remains unclear is whether or not end demand will pick up and sustain economic growth in the second half of this year.

We believe employment trends will be a key determinant of the strength and sustainability of this recovery. Unfortunately, today's unemployment rate is at a level that we have not seen in a generation. Although investors might be watching for a positive surprise on the unemployment front, if the unemployment rate settles at a much higher rate than what we've seen over the past 30 years, it could have rather dramatic implications for an economy that is largely driven by the consumer. An unemployed consumer won't be able to do much spending. A cautious consumer who decides to save rather than spend won't be able to do much for short-term economic growth either.

Finally, as discussed later is this newsletter, the economy faces some major debt issues. These include the refinancing of another wave of home mortgages with adjustable interest rates, the maturing of a large tranche of commercial real estate loans, the rollover of corporate debt and the financing of the federal government's increasing deficits.

Once again, our concern is not that the economy will never recover. Our concern is that the stock market has priced in an over-optimistic view of this recovery and is vulnerable to some setbacks. The combination of the powerful and uninterrupted rally along with no risk premium for market volatility has us less sanguine than some of our competitors.

These potential risks have made you more cautious in your allocations to equities. Do you see this strategy changing?

When investors wanted to rush for the exits and liquidate all their equity holdings early last year, our investment disciplines and philosophy of diversification kept us in the game. As the markets climbed higher over the course of the year, we reduced our allocation to global equities on several different occasions. At the end of the year, our asset allocation strategy called for approximately 50% of moderate growth/moderate risk portfolios to be invested in global equities ("higher risk" assets). Our analysis of where we stand today suggests an aggressive posture is not warranted. At current levels, the equity markets appear overbought and sentiment is at the more bullish end of the spectrum. Not only is the fire sale in stocks over, but it appears that stocks may not be on sale at all at this point in time. As mentioned earlier, the U.S. economy is not out of the woods yet; it has to work through many challenges with respect to debt rollovers, continued housing weakness, very high unemployment, weak income trends and a possible building up in the savings rate.

We urge patience at this time. Stock market crashes born out of financial crises historically take longer to recover from and are prone to volatile swings. It is our view that the market has moved too far, too fast. Could stocks go higher? Yes, they could but, with valuations at

Looking forward after a year of reversals (continued)

one standard deviation higher than normal, earnings expectations too high and a rally that seems to have taken a sustained economic recovery for granted, we contend this is not the time to become aggressive buyers of stock.

What opportunities do you see for 2010?

Commercial real estate, after a very difficult 2009, is shaping up to be a very attractive asset class. However, as with any opportunity, this asset area is still fraught with risks. From its peak in 2007, the S&P 500 index dropped -57% and then rallied 65% by year end. The MSCI EAFE index for developed markets around the world fell -62% from peak levels and then rallied 83% by year end. Emerging market equities, as measured by the Morgan Stanley Emerging Free index, staged a similarly stunning comeback. After falling -65% from peak values, emerging markets rallied 78%. The Moody's Commercial Property Index has now fallen approximately -47% from the peak reached in 2007. By this measure, real estate has fallen almost as much as stocks did, but as yet has not seen a pickup in values.

While commercial real estate is a unique asset class given its illiquidity, it is at a point today where the upside potential appears to be significantly greater than the downside risk. Cap rates (a measure of a property's income relative to its equity) are close to 8% at today's values, significantly above bond yields. Real estate hasn't stopped declining, but the pace of the decline has slowed. If one is looking for value, this is an asset class that could reap attractive returns over the long run.

The other opportunity that we see is in quality stocks across the globe. Last year's stock market rally has often been referred to as a "junk" rally because lower quality stocks performed significantly better than higher quality stocks. In fact, according to a Bernstein research report, from March to December of 2009, the lowest quality stocks outperformed the highest quality stocks by close to a 50% annualized rate! As with any investment, when the pendulum swings too far in one direction or the other, a correction is usually in the offing. While junk has outperformed quality coming out of past recessions, the magnitude of last year's outperformance was stunning. Over the long term, quality investing has historically prevailed. We are looking for a return to quality investing in 2010.

Longer term, emerging markets are of great interest to us. By 2050, 80% of the world's GDP growth is expected to occur outside the U.S., Canada and Europe. An even more startling fact is that, by 2030, the developing world's middle class alone is projected to be larger than the total population of Europe, Japan and the U.S. combined. As the developing markets gain more importance on the world stage, they will be deserving of a permanent place in our investment strategy for the long term.

We are looking for a return to quality investing in 2010.

The recovering economy faces a difficult balancing act

Third quarter economic growth in the U.S., after originally being reported up 3.5%, was revised down to 2.2%. The fourth quarter of 2009 is likely to show even better growth of around 4%, with some estimates as high as 6.5%. Most of the growth is expected to come from less inventory liquidation.

The question we posed last quarter remains valid today: "Is the recovery sustainable or artificial and vulnerable to a double dip?" Economic growth has been largely supported by temporary fiscal stimulus in the form of housing tax credits, cash for clunkers and federal government spending. Is the economy ready to stand on its own? Unfortunately, we will not know for a while. Economic trends will likely remain very difficult to decipher. The housing credit has been extended and expanded and federal spending is likely to continue to grow. Although the new $154 billion stimulus bill currently moving through Congress is considerably less than last year's $780 billion stimulus bill, if passed, it could add as much as 1% to GDP growth.

We believe a robust recovery will be difficult to achieve.

Unemployment an Obstacle to Growth

Until employment and incomes begin to grow at a sustainable rate, we believe a robust recovery will be difficult to achieve. The unemployment picture is particularly grim; the unemployment rate is around 10%, with nearly sixteen million people out of work and another ten million people working part time because they can't find full-time work, resulting in an underemployment rate of close to 17.5%. The number would be even worse if two million discouraged workers hadn't dropped out of the labor force altogether. These people are not counted as unemployed since they aren't in the labor force. Including these discouraged workers, underemployment in the U.S. is close to 20%.

The good news is that employment is not deteriorating as fast as in previous months and employment may be near an irreducibly low level. In addition, unemployment claims, although still high have fallen sharply, indicating fewer layoffs. Unfortunately, there is little indication of net job creation, as the number of people collecting unemployment through the regular benefit program and through the emergency and extended benefits programs has not fallen. With productivity and profit margins rising, corporations are likely to be slow to rehire until top line growth accelerates.

For sustained top line growth, the consumer, which accounts for 70% of U.S. GDP, needs to start spending. In traditional inventory-driven recessions, once inventories are brought under control companies begin to rehire, setting the stage for increased consumer spending and robust growth. The fact that the best growth historically has come out of the depths of recession gives hope for a "V-shaped" recovery. However, in recessions triggered by financial crises and excessive leverage, sustained recoveries historically haven't begun until excesses are reduced and balance sheets have been restored. While consumer debt has come down, a lot of debt still needs to be retired and many assets still need to be written down. In addition, due to an increase in government borrowing, the overall economy is more in debt than ever.

As a result, we believe the U.S. economy will experience a greater than normal lag time before employment growth turns. The Organization for Economic Cooperation and Development concurs. In December, it warned that, while growth in the U.S. and other industrialized economies has resumed, the unemployment rate will probably rise well into 2010. Even if companies begin to rehire over the coming months, the unemployment rate is likely to remain sticky as labor force growth accelerates, discouraged workers return to the work force and part-timers fill full-time positions.

In an environment of high unemployment, wage growth should be muted and personal income growth subdued. If it weren't for a spike in government transfer payments, incomes would be growing very little. Government transfers help in the short term but do little to sustain long-term growth.

Impact of Federal Deficit

With deficits and debt growing at unsustainable rates, eventually the U.S. government must scale back or risk losing all credibility with the foreigners that hold our debt. Currently the U.S. is running a $1.5 trillion budget deficit. In the past, foreigners were willing holders of U.S. debt since they were merely recycling dollars they earned from our trade deficit back into dollar assets.

The recovering economy faces a difficult balancing act (continued)

Currently, we have a situation where the trade deficit has shrunk from over $700 billion to less than $350 billion. This leaves a shortfall of over $1 trillion ($1.5 trillion minus $350 billion) that needs to be financed domestically. While the savings rate has increased, the main domestic purchaser of U.S. debt has been the Fed. Over the last two years, Fed assets (primarily government securities) have ballooned from around $800 billion to $2.2 trillion. The Fed is printing money to support the government's spending. Eventually, these assets will need to be sold or we will risk serious inflation.

Currently, the economy has plenty of slack to absorb inflationary pressures. However, once economic activity accelerates, this liquidity will be released and could overwhelm monetary policy and create price or asset inflation. In that event, the Fed is likely to move quickly to raise rates to counter inflationary pressure. Given the fragile nature of the housing market, this could trigger a renewed downturn. So far, the Fed still sees the recovery as fragile and continues to say that it will not raise rates for an extended period to avoid jeopardizing growth. However, long before the Fed acts, both domestic and foreign bond vigilantes are likely to push rates higher. We are beginning to see some of the pressure already, as U.S. Treasury bond yields are well off their lows.

Our base case for the economy continues to call for below trend growth until the consumer regains its footing. With stocks discounting a more robust recovery, slower growth could be disappointing to investors. Even if growth returns as expected, it is likely to be accompanied by much higher interest rates, which could be disconcerting for investors.

Systemic Problems Still Pose Risks

In addition, a number of systemic problems could derail the recovery. Although the housing market is getting a boost from increased affordability and government sponsored programs giving "free money" to homebuyers, a huge pool of distressed homeowners still need to refinance. In 2010, over $350 billion in option adjustable rate, Alt-A and subprime loans will be coming due and need to be refinanced. Commercial real estate has about $300 billion in loans to rollover. Global banks have over $2 trillion in debt to roll and U.S. corporations $350 billion. To top it all off, as noted before, the federal government has $1.5 trillion to finance.

Finally, it is unclear that the housing crisis is over. While the pace of home price declines has slowed and the housing market has benefitted from government sponsored lending, delinquencies and foreclosures continue to rise month after month. With mortgage resets pending, another wave of distressed selling could hit the market before the first wave has subsided.

The biggest problem for the economy is that the malinvestment and leverage of the previous decade have yet to be worked off and balance sheets restored. Government stimulus can help temporarily by pulling demand forward, but it creates other problems. Excess Fed stimulus has put inflation risk back in play. Rising deficits could put the dollar at risk. Until the excesses are worked off, sustainable robust growth could be elusive. In the meantime, the economy can move forward but faces a difficult balancing act.

The malinvestment and leverage of the previous decade have yet to be worked off.

Developing countries are likely to have the strongest growth

As long as unemployment and weak consumption are plaguing the U.S., the rest of the developed world is unlikely to enjoy robust growth. Growth prospects in emerging economies are apt to be better as these countries build out their domestic economies. However, they are still dependent on exports to the U.S., the biggest consuming country in the world. If the U.S. falters, growth prospects in the developing nations will also be diminished. That said, many emerging countries have fewer constraints to growth. They have stronger demographic profiles with younger and growing populations. Their banks weren't hit as hard as those in developed countries during the recent crisis and foreign reserves remain stronger. As a result, they possess the labor and capital resources that are the key ingredients to growth.

Europe

The Eurozone remains soft with third quarter growth rising 1.6% annualized but still down -4.1% year-over-year. Retail sales in the fourth quarter started off on a weak note and consumer confidence remains negative. The Manufacturing Purchasing Managers Index (PMI) has moved back above 50, indicating that growth in the manufacturing sector is improving, albeit from very depressed levels. Despite the improvement in the PMI, industrial production has yet to gain any serious traction. Construction activity continues to fall to new lows. Although exports and imports have been volatile around a flat trend, they may receive an assist from the recent decline in the euro. M3 growth and lending activity is dormant much like in the U.S. The money multiplier also continues to fall. It is unlikely that the European Central Bank will raise rates anytime soon given falling inflation and sluggish economic conditions.

United Kingdom

Britain's Leading Economic Indicator (LEI) is heading higher, suggesting near-term growth prospects should improve. However, coincident indicators have been slow to respond. Retail sales are grudgingly moving higher, boosted by auto incentives, while industrial production has yet to seriously turn off the bottom. The housing sector has stabilized. It is moving higher as both home prices and mortgage approvals increase. Government spending, a relatively soft pound and expansive monetary policy may be working, albeit anemically. Given the soft economic activity, weak lending and low inflation, the Bank of England is unlikely to raise rates.

Japan

GDP flattened out in the third quarter, falling only -0.4% annualized and -4.4% year-over-year. Japan's LEI is trending higher, which indicates stronger growth ahead. However, stock prices are not confirming this forecast as the Nikkei 225 is lagging the rest of the global equity markets. The economy is having a hard time gaining traction due to weak labor markets, a declining housing sector, lower retail sales, falling bank lending, and flat exports and imports. However, the rate of decline has slowed, the Tankan survey (a measure of business confidence) is starting to trend higher, and industrial production has moved off the bottom. In addition, the inventory to shipment ratio is falling sharply. Inventories, while still a bit high, are no longer alarmingly high.

China

Third quarter GDP expanded at an 8.9% rate over the last year after plunging to 6% earlier in 2009. With the LEI rising above its last cyclical high, growth prospects are encouraging. Despite a slowdown in employment growth, retail sales have expanded due in part to rebates on autos and appliances. Both the PMI and industrial production are signaling a recovery in the manufacturing sector. Bank lending has been trending sharply higher and is above its long-term growth trend. The rapid growth in China's monetary base is likely to rekindle inflation concerns, particularly given the strong historic relationship between monetary growth and rising prices. The central bank is already beginning to lean against loan expansion by slowing the growth in the monetary base. It may also have to allow China's currency to move higher as it raises interest rates. Chinese stocks have started to lag the rest of the world. This is somewhat disconcerting, since they led going into and coming out of the recession. However, Chinese stocks had a good run in 2009 and this may be just a temporary pause to recharge.

Developing countries are likely to have the strongest growth (continued)

India

GDP increased 7.9% year-over-year in the third quarter as industrial production and electricity production continued to trend higher. Consumer spending was boosted by auto sales. The trade deficit is widening, which will be a drag on growth. However, imports are rising faster than exports, indicating that the domestic economy is leading growth. The Reserve Bank of India is likely to respond to double-digit inflation by raising rates. Yet, the increase in the rupee is already providing de-facto tightening. As a result, the central bank may wait for the rupee to weaken before increasing rates. Higher interest rates could boost the rupee further.

Brazil

GDP increased at a 5.2% annualized rate in the third quarter of 2009. With job growth, hours worked and production moving higher in the fourth quarter, growth is likely to increase again. However, retail sales have gone flat, led by a drop in auto sales. Housing starts fell in October. Exports and imports also turned down, suggesting that the strength in Brazil's currency may be impacting growth. Inflation, at 4.2%, is fast approaching the central bank's target rate of 4.5%. This raises the possibility that the bank could push rates higher.

As long as unemployment and weak consumption are plaguing the U.S., the rest of the developed world is unlikely to enjoy robust growth.

A relatively weak fourth quarter ended a year in which riskier bonds had the best performance

The bond markets exhibited relatively weak results in the fourth quarter, as longer-term yields rose across most fixed-income sectors. The broad-based Merrill Lynch U.S. Corporate, Government and Mortgage index was flat for the three months.

Treasuries, as measured by the Merrill Lynch U.S. Treasury Master index, lost - 1.3% (longer-term Treasuries lost more than that). According to their respective Merrill Lynch Master indices, investment grade corporates gained 1.2% and mortgages added 0.5%. At the riskier end of the spectrum, high yield debt (Merrill Lynch High Yield Cash Pay index) added to an already great recovery in 2009 with a 5.8% return for the quarter. The Merrill Lynch Municipal Master index of municipal debt, on the other hand, lost -1.3% as investors' anxiety over state deficits finally restrained retail demand.

By year end, yield spreads had fallen close to their long-term historic averages.

For 2009 as a whole, investors' risk tolerance increased. U.S. Treasuries posted negative returns as investors no longer sought safety. The yield on 30-year Treasuries rose from an all-time low of 2.7% at the beginning of the year to 4.6% by year's end. Despite this increase in interest rates, yields on riskier bonds fell as the demand for higher risk debt soared. This allowed high yield debt to return an amazing 56.3% and municipal bonds a respectable 14.5% last year, as measured by their respective Merrill Lynch Master indices. By year end, yield spreads had fallen close to their long-term historic averages.

High Yield and Municipal Bonds No Longer as Attractive

In our opinion, 2010 doesn't bode as well for these two fixed-income sectors. For high yield bonds, the extra yield offered over Treasury debt has declined dramatically and now represents only slightly good value; for municipal debt, rich yields are gone and risks are only slightly lower than a year ago.

The municipal bond market probably feels even riskier than it actually is because investors now have greater clarity regarding the extent of the states' economic difficulties. U.S. state fiscal deficits are currently estimated to total $190 billion this fiscal year and $180 billion next year. While the magnitude of these state deficits is daunting, we continue to believe that: 1) the federal government would never allow a state general obligation default due to the collateral damage it would do to municipal finance broadly; 2) during 2010, a lot of federal stimulus money will be directed to the states (2011 poses a greater risk from this perspective); and 3) recent signs of increased consumer confidence could presage an increase in sales tax revenue, which tends to turn up long before income tax revenue as the economy pulls out of a recession. (Sales and income taxes are the two major sources of state revenues.)

FOREIGN EXCHANGE

2009 ended with a bout of schizophrenia in the foreign exchange markets. After eleven months of relatively consistent declines against all major currencies, the greenback showed some backbone in December, rising strongly against the Japanese yen and the euro (7.3% and 4.3%, respectively). Commodity producers like Canada, Brazil and South Africa were the only major currencies to fare well against the dollar toward year's end. The December market action dominated the results for the fourth quarter, during which the yen fell -3.7% and the euro lost -2.1% versus the dollar (with the currencies of commodity-based economies faring far better).

This was a dramatic turnaround from the year as a whole, during which most currencies trounced the dollar by amounts that ranged from the small (2.7% for the euro) to the large (more than 20% for Brazil, South Africa, Australia, New Zealand and Norway). The Japanese yen was the only major currency to decline relative to the dollar in 2009.

Outlook for the U.S. Dollar

The question that dogs the current outlook for the dollar is the direction and timing of U.S. fiscal and monetary policy. While subtle signs of growth in Asia have led to increases in short-term interest rates there, U.S. policy-makers have so far not signaled an intention to tighten monetary policy. As a result, the U.S. continues to be the cheapest source of borrowing globally and therefore a candidate for structural currency weakness. However, the foreign exchange markets have begun to price in a potential rate

A relatively weak fourth quarter ended a year in which riskier bonds had the best performance (continued)

increase by mid-year which, if it comes to fruition, would likely prove dollar positive. The fiscal picture is murkier. Minutes from the recent Fed meetings in December indicated that it saw the potential need for further fiscal stimulus. Given the dramatic increase in the federal deficit, the prospect of ongoing spending would likely send the dollar down against most of its trade partners.

The U.S. continues to be a candidate for structural currency weakness.

Emerging Market versus Developed Market Currencies

A good structural case can be made for the continued strength of emerging market currencies versus the dollar, particularly given the relatively strong expected growth rates in Asia and Latin America. The dollar's fate relative to the developed world is more uncertain. The U.S., the U.K., Continental Europe and Japan are all afflicted with economic ailments. Economic growth combined with modest inflation and controlled government debt is the obvious formula for a healthy currency. It is currently difficult for us to discern which patient—the U.S., Continental Europe, the U.K. or Japan—will turn out to be the halest.

The U.S. stock market continued to rally in the fourth quarter

The S&P 500 index rose 6.0% in the fourth quarter and finished the year up over 26%. The NASDAQ 100 index did even better (up 8.4% for the quarter and 54.6% for the year). Although the S&P Small Cap 600/Citigroup Value index trailed the pack, it still posted very respectable returns (up 4.5% for the quarter and 22.9% for the year).

The most interesting thing about 2009 was the flight from quality.

Most readers of this newsletter will be familiar with the supposed ancient Chinese curse, "May you live in interesting times." While the curse's true origins are obscure (most likely neither ancient nor Chinese), its meaning is clear—a sort of "be careful what you wish for" combined with a mild dose of ill will. Well, 2009 was certainly filled with interesting times, from the early fears of economic depression and a stock market panic to a barely foiled bomb plot on Christmas day. While there are likely few who would complain about the S&P 500's double-digit return for 2009, most investors found the stock market's 25% plunge in the first two months or so of the year to be far more interesting than they liked.

The Flight from Quality in 2009

Within the U.S. stock market itself, the most interesting thing about 2009 was the flight from quality. Like the plane crash survivor who suddenly goes on a lottery ticket buying spree because he is so "lucky", investors—once they realized that an economic depression was not in the offing—threw their money at low quality stocks that would have been the first to go bankrupt had the recession worsened. While a little bit of this type of behavior is to be expected after any traumatic event, sobriety almost always returns. The surprising thing about 2009 was how long the low quality stock party lasted.

Low quality stocks soared on the promise of improved earnings for much of 2009. However, quality finally began to show the first signs of being rewarded again in the fourth quarter, and we believe this trend should accelerate in 2010. As time progresses, it is likely that low quality companies with poor profit margins, low asset turnover and poor to negative cash flow will have difficulty meeting investors' expectations. Conversely, since high quality stocks with high profit margins, rapid asset turnover and positive cash flow have not been bid up by investors, they should have a much easier time meeting and beating expectations.

The Outlook for 2010

Looking further into 2010, it is difficult to envision full year U.S. stock market returns that are as robust as those that were experienced in 2009. Valuations were incredibly cheap at this time last year, whereas the S&P 500 index's median price-earnings ratio is now over 22 times earnings, rich by historical measures. On the positive side, earnings should grow in 2010. Legislative uncertainty should also lessen, even if the end result is generally unfriendly toward business. It is important to remember that businesses and investors typically prefer a known negative to uncertainty, because a known negative allows for planning and work-arounds, while uncertainty does not. In a nutshell, 2010 looks to be less interesting than 2009 and, for many investors, that would be just fine.

International stocks also posted positive returns

After double-digit gains in both the second and third quarters of 2009, international stocks advanced at a gentler pace in the fourth quarter. The MSCI EAFE index of developed markets returned 2.2% for the three months, while the MSCI Emerging Market index rose 8.5%

Returns were large and divergent for 2009 as a whole. The MSCI EAFE index advanced 31.8%, about what one would get by adding the impact of a weak dollar to the U.S. stock market's return. The MSCI Emerging Market index, on the other hand, rose an astonishing 78.5%, representing the single best calendar year in the 22-year history of the index (and following close on the heels of its single worst year in 2008). Moreover, the MSCI country indices for Brazil, Russia, India and Indonesia all doubled in value over the twelve months. (All indices are net dividends and presented in U.S. dollar terms.)

A Closer Look at the Fourth Quarter

During the fourth quarter, stock price volatility and investor risk aversion continued to decrease. By year's end, our proprietary measure of global risk was back below its long-run average for the first time since 2007—quite an improvement on the rudderless panic gripping the investment world after the collapse of Lehman Brothers just over a year ago. Coordinated monetary easing and fiscal stimulus were given the credit for bringing the world back from the brink of financial collapse and economic depression. As a result, when investors heard the G-20 countries agree to maintain their government spending or the Fed all but promise 0% financing for the foreseeable future, they were inclined to take the comforting news at face value and not to worry about any long-term ramifications.

While the U.S. and Western Europe kept interest rates low and credit easy to help protect the fragile economic recovery, Australia's central bank kicked off October with a surprise interest rate hike. This indication of confidence in the economy's growth potential said much about the continued strength of resource demand from Asia (and China in particular). It also helped start the quarter in an optimistic direction.

The quarter ended with a welcome break in the pattern that had been in place since March, in which there was an inverse relationship between the dollar and other risky assets (like stocks and commodities). Before December, the dollar fell when the price of "risky assets" rose, and rose when all the other prices fell. In December, the dollar reversed course and began to strengthen even as oil and other commodity prices continued to rise. This was a welcome development for us as managers, if only because the previous inverse relationship (an oversimplified, binary expression of investor risk tolerance versus aversion) did not create a good environment for nuanced, systematic investment strategies.

Winners and Losers

The quarter's winners among developed markets included resource producers Norway, Canada and Australia. The biggest losers were Austria and Greece. Confidence in these peripheral euro currency markets was shaken by the threat of sovereign debt default in Dubai. Austria and Greece were seen as particularly vulnerable because they combined large budget deficits and foreign debt obligations with the inability to devalue their currency or set an independent monetary policy. Spain, Portugal, Italy and Ireland were also adversely affected by similar concerns.

The best emerging market returns during the fourth quarter came from Brazil, Mexico, Chile and Argentina. However, nearly all emerging market countries achieved stock market gains in excess of the developed market average.

Looking Forward

Companies in the developed world have on the whole done a good job at exceeding earnings expectations by keeping costs under control and preserving profit margins. Nevertheless, we believe firms with exposure to emerging markets will have the best and quickest prospects for sales and earnings growth in the year ahead.

We believe firms with exposure to emerging markets will have the best prospects.

There are glimmers of hope for commercial real estate

Commercial real estate continues to generate negative headlines featuring falling rents, rising vacancies, surging loan defaults and property owners filing for bankruptcy protection. However, some good news seems to be on the horizon.

The worst may be behind us.

Transaction volume may have bottomed. According to Real Capital Analytics, after just $9 to $10 billion in sales in each of the first two quarters of 2009, third quarter transactions totaled almost $13 billion. Moreover, the fourth quarter is likely to exceed that volume. As sellers have recognized the limited demand for problem properties, higher quality product has returned to the market, prompting a pickup in sales.

Risk Averse Buyers

But buyers remain risk averse. Anecdotal evidence would seem to indicate that high quality properties (particularly apartments, for which financing remains readily available thanks to the Government Sponsored Enterprises like Fannie Mae and Freddie Mac) generate strong interest and numerous offers from potential buyers. Lower quality properties and locations (especially properties with existing vacancy or upcoming rollover that lack "durable income") may receive no offers at all. Why the bifurcation in the market? Buyers and their lenders are looking for a bulletproof income stream to help them bridge the gap to better economic times, creating an opportunity for those buyers willing to take on more risk.

Thawing Debt Markets

The debt markets also appear to be thawing. In recent months, several single-borrower collateralized mortgage backed securities transactions have closed. Life insurance companies have also shown a renewed appetite for lending. These are positive signs for the debt markets, albeit with limited effect to date. In addition, lenders have demonstrated a willingness to extend loans with upcoming maturities. While looming maturities of commercial real estate debt have thus far not triggered the avalanche of fire sales that were feared to drive down prices precipitously, the consequence of the "pretend-and-extend" lender mentality means that working through the distress may be a protracted affair. Debt, while becoming somewhat more available, is still very costly, with stringent covenants and "belt-and-suspenders" type underwriting standards. However, the current state of the commercial real estate credit markets is certainly an improvement from the frozen markets of earlier last year.

Moderating Value Declines

Valuation declines continue to moderate. After reporting appreciation returns of -14.9%, -10.5% and -8.9% in the first three quarters of 2009, the NCREIF National Fund Index's value declines are expected to moderate further in the fourth quarter. So, the worst may be behind us.

Commercial real estate valuations are based in part on projections of rent growth, vacancy rates and the time it takes to lease up empty space. In order for values to stabilize and ultimately rise, the rate of net operating income deterioration will have to slow relative to the expectations that are embedded in valuations. Job growth is needed to generate these "positive earnings surprises." While fundamentals in many markets will continue to erode—commercial real estate vacancies and rents lag the broader economy—the recent declines in job losses are an encouraging step in the right direction.

Next quarter, we'll take a look at the year-end results for the commercial real estate sector as measured by the NCREIF National Property Index and the NCREIF National Fund Index.

We are making no changes to our asset allocation strategy at this time

U.S. Stocks: Underweight

The sharp rally in stocks since March has pushed valuations to the upper end of the fair value range. Investors, after discounting Armageddon earlier in the year, are now betting on a sustainable robust recovery. So far, stock prices have been pushed higher by better than expected earnings growth as margins expanded on the back of lower labor costs. Since future labor cost gains will likely be more difficult to achieve, top line revenue growth is needed to spur stronger earnings growth. If the economy expands as expected, top line growth should come through. However, in that environment, interest rates are likely to rise sharply, providing stiff competition for equities and pushing P/E multiples down. If the economy continues on a slow growth trajectory, it could buy more time for stocks to work their way higher as the rise in interest rates might be postponed. If the economy stumbles again, stocks would be vulnerable after a 60% run off the bottom. Currently the trend is very positive and stocks keep moving higher. The combined wisdom of the market and our discipline to maintain diversified portfolios argues against reducing stock allocations further at this time. If the market were to pull back significantly but remain in an uptrend, we could start adding to stocks.

International Stocks: Neutral

Like U.S. stocks, foreign markets have moved sharply higher from depression like levels and appear to be ahead of themselves. Emerging markets (which were less scathed by the financial crisis and which have better long-term growth prospects) have rallied the most. U.S. based investors have benefited from dollar weakness as well as higher stock prices. Recently, the dollar has strengthened, removing one of the legs contributing to international outperformance. It remains to be seen whether the turn in the dollar is sustainable or just a short covering rally. Given the excessive printing of dollars and likely slow reversal in Fed policy, the recent upturn in the dollar may be short-lived. We continue to see long-term opportunity in international stocks, particularly emerging markets, but are concerned they have rallied too far too fast and would be vulnerable to any setback in the U.S.

Bonds: Underweight

The ten-year U.S. Treasury bond yield increased 60 basis points (0.6%) to 3.8% in the fourth quarter. It also rose 125 basis points (1.25%) in 2009. Despite this increase in yields, our analysis indicates that bonds are still extremely overvalued and yields are too low. We continue to see bonds as an insurance policy against deflation and as partial protection for portfolios should the recovery begin to stumble. The interest rate risk in bonds is not trivial. While the stock market is discounting stronger growth, bonds are still discounting anemic growth. If stock investors are right, bond yields could move much higher, pushing bond prices lower.

Real Estate: Neutral*

Commercial real estate still faces a very difficult economic and financial environment and has yet to stabilize. Rents continue to fall and vacancies rise. Maturing commercial loans could be a problem if banks don't find ways to extend new credit. Recently, we have seen banks more willing to "extend and pretend". With cap rates above 8%, real estate is looking more attractive on a relative and absolute basis. However, if property owners can't roll over their loans, distressed sellers could become more prevalent in the market and prices could remain under pressure. One glimmer of hope is that commercial real estate lagged the equity market on the way down and is lagging it on the way up. If the stock market is right and better times are ahead, real estate has some catching up to do. At some point, we may decide to top up our real estate portfolios.

Alternative Investments*

We are constantly looking for ways to enhance returns and/or lower risk in portfolios. Some alternative strategies offer diversifying opportunities to offset risk inherent in equity portfolios. Other strategies seek to enhance returns by applying specialized expertise and rigorous methodologies to target long-term investment opportunities.

*Real estate and alternative investments are not suitable for all investors.

If the market were to pull back significantly, we could start adding to stocks.

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U.S. INTEREST RATES	3/31/2009	6/30/2009	9/30/2009	12/31/2009
Cash Equivalents				
90-Day Treasury Bills	0.21%	0.20%	0.12%	0.06%
Federal Funds Target	0.25%	0.25%	0.25%	0.25%
Bank Prime Rate	3.25%	3.25%	3.25%	3.25%
Money Market Funds	0.72%	0.29%	0.21%	0.06%
Bonds				
30-Year U.S. Treasury	3.54%	4.33%	4.05%	4.64%
20-Year AA Municipal	4.93%	4.84%	3.86%	4.11%

Sources: Datastream International and Bloomberg, L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US$) THROUGH 12/31/09	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7–10 Year Treasury Index	-2.23%	-5.86%	-5.86%
Merrill Lynch 7–10 Year Agency Index	-0.64%	-0.09%	-0.09%
Merrill Lynch 5–10 Year Corporate Index	1.82%	23.31%	23.31%
Barclays Capital Municipal Bond Index	-0.96%	12.91%	12.91%
International Bonds			
Citigroup non-US$ World Government Bond Index, fully hedged	0.13%	2.38%	2.38%

Sources: Bloomberg, L.P. and S&P Micropal

GLOBAL STOCK MARKET TOTAL RETURNS (US$) THROUGH 12/31/09	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average Index	8.09%	22.70%	22.70%
S&P 500 Index	6.04%	26.47%	26.47%
NASDAQ 100 Index	8.39%	54.63%	54.63%
S&P SmallCap 600/Citigroup Value Index	4.45%	22.86%	22.86%
International Stocks			
MSCI Japan Index, net dividends	-2.76%	6.25%	6.25%
MSCI Europe (includes UK) Index, net dividends	3.24%	35.83%	35.83%
MSCI EAFE (Europe, Australia, Far East) Index, net dividends	2.18%	31.78%	31.78%

Sources: Bloomberg, L.P. and S&P Micropal

REAL ESTATE TOTAL RETURNS (US$) THROUGH 12/31/09	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF National Property Index*	-3.32%	-17.89%	-17.89%

Source: The National Council of Real Estate Investment Fiduciaries

*Return for latest quarter is lagged by one quarter.

Past performance is no indication of future results.

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About *the 9:05*

Since 1978, we've held a weekly company wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as the 9:05.

Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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